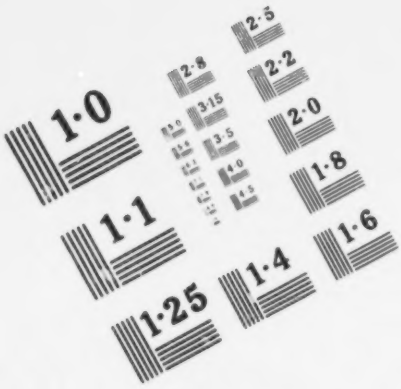

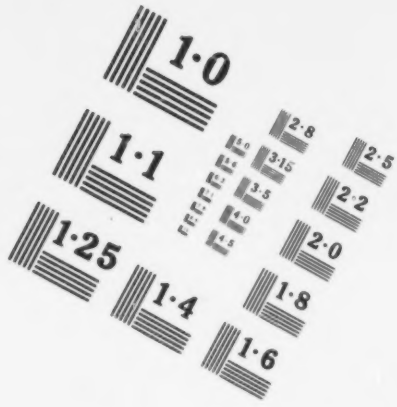

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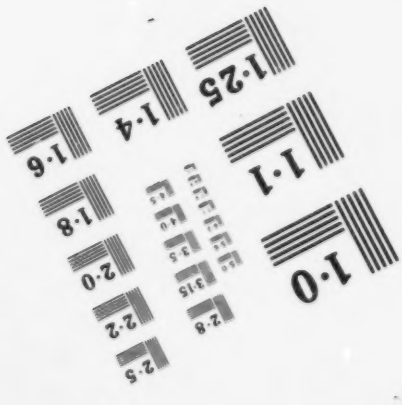

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Tax Information on Corporations

For use in preparing
1990 Returns

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Important Changes for 1990

Issuance of stock. For otherwise nontaxable transfers of money or property to a corporation in exchange solely for stock or securities of the corporation made after October 2, 1989, and in some instances July 11, 1989, gain (if any) is taxable to the extent of securities received.

Reduction in basis of stock. For stock issued after July 10, 1989, the rules on an extraordinary dividend received on a share of stock will now apply to a dividend on disqualified preferred stock without regard to the period the corporation held the stock.

These rules apply to stock issued after July 10, 1989, unless issued under a written binding contract in effect on that date.

Interest paid to related tax-exempt parties. For tax years beginning after July 10, 1989, a deduction for certain interest paid by a corporation to related parties not subject to tax on the interest received is not allowed. The amount of disallowed interest is carried to subsequent years.

Alternative minimum tax. For tax years beginning after 1989, the following changes have been made to the minimum tax rules.

The ***alternative depreciation system*** is used for property placed in service after 1989. This requires use of the straight-line method over a recovery period.

Intangible drilling costs are capitalized and amortized over a 60–month period beginning with the month the costs were paid or incurred.

Depletion is computed using the cost depletion method for property placed in service after 1989.

The ***credit*** allowed against regular tax for alternative minimum tax on deferral and exclusion items paid in previous years is increased by any credit not allowed by the limit for orphan drugs or nonconventional fuels.

The ***limit on foreign tax credit*** does not apply to certain corporations.

Introduction

This publication is primarily concerned with ordinary domestic corporations that are subject to general tax laws. It explains the tax law in plain language so that it will be easier to understand. However, the information provided does not cover every situation and is not intended to replace the law or change its meaning.

Some corporations may meet the qualifications for electing to be S corporations. For a detailed discussion of this type of corporation, see Publication 589, *Tax Information on S Corporations*. Also see Publication 536, *Net Operating Losses*, if the corporation has an operating loss.

See filled-in Forms 1120 and 1120–A at the end of this publication.

Free publications and forms. If you need information on a subject not covered in this publication, you may check our other free publications. To order publications and forms, call our toll-free telephone number 1–800–829–3676 or write to the IRS Forms Distribution Center for your area as shown in the income tax package.

Definitions

A ***corporation,*** for federal income tax purposes, includes associations, joint stock companies, insurance companies, trusts, and partnerships that actually operate as associations or corporations.

Professional organizations. Organizations of doctors, lawyers, and other professional people, organized under state professional association acts or corporation statutes, are generally recognized as corporations for federal income tax purposes. To be classified as a corporation, a professional service organization must be both ***organized*** and ***operated*** as a corporation. All states and the District of Columbia have professional association acts.

Unincorporated organizations. Unincorporated organizations having certain corporate characteristics are classified as associations that are taxed as corporations. To be treated as a corporation for tax purposes, the organization must have associates, be organized to carry on business, and divide the gains from the business. In addition, the organization must have a majority of the following characteristics:

Continuity of life,

Centralization of management,

Limited liability, and

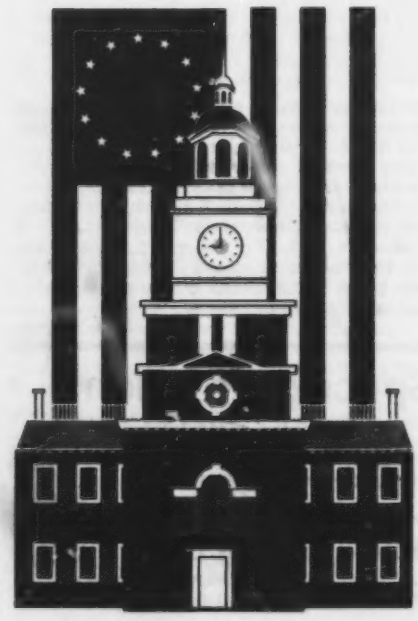
Free transferability of interests.

The presence or absence of these characteristics must be taken into account in determining whether an organization is an association. The facts in each case determine whether or not the characteristics are present.

However, other factors may be significant in classifying an organization as an association. An organization will be treated as an association if its corporate characteristics make it more nearly resemble a corporation than a partnership or trust.

Forming a Corporation

Forming a corporation involves a transfer of money, property, or both by prospective shareholders in exchange for capital stock in the corporation.



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Issuance of Stock

If one or more persons transfer money or property to a corporation solely in exchange for stock of that corporation, and immediately after the exchange the transferor or transferors are in control of the corporation, no gain or loss is recognized either to the transferors or to the transferee corporation.

The transferors must be in control of the corporation immediately after the exchange. To be in control, the transferors must, as a group, own:

- At least 80% of the total combined voting power of all classes of stock entitled to vote, and
- At least 80% of the total number of shares of all other classes of stock.

Transfer of services. Transfer of your services to a corporation in return for stock results in taxable compensation to you.

Property or money received. If you receive property or money in addition to stock in exchange for the property you transferred, your gain (if any) is taxable to the extent of the money or fair market value of property received.

Transfer of mortgaged property. If you transfer mortgaged property to a controlled corporation, or if the corporation assumes your liabilities or takes property subject to liability, there is no gain or loss recognized. However, if you had no bona fide business purpose, or, if the liabilities were transferred or assumed for the purpose of avoiding federal income tax on the exchange, you have taxable gain to the extent of the liabilities transferred or assumed. If the exception does not apply, but the corporation assumes or takes property subject to liabilities in excess of the adjusted basis of the transferred property, the excess is a taxable gain.

Gain or loss not recognized. No gain or loss is recognized by a corporation if you transfer property and money to the corporation in exchange for corporation stock (including treasury stock). A corporation does not recognize gain or loss on the acquisition or lapse of an option to buy or sell its stock (including treasury stock).

Gain or loss determined. The gain or loss on a taxable exchange is determined by comparing the adjusted basis of the property transferred with its fair market value at the time of transfer to the corporation. This may be a capital gain or loss.

Transfer to foreign corporations. Generally, gain will be recognized on the transfer of property to a foreign corporation. Exceptions allow nonrecognition of gain on a transfer of certain property, such as a foreign corporation using the property in the active conduct of a trade or business outside the United States.

Basis of Stock

The basis of stock received in exchange for the transfer of property to a corporation is the same as the basis of property transferred ***decreased*** by:

- The fair market value of any other property (except money) you receive,
- The amount of any money you receive, and
- Any loss you recognize on the exchange; and ***increased*** by:
- Any amount treated as a dividend, and
- Any gain recognized on the exchange.

The basis of property received, other than money or stock, is its fair market value.

Before October 2, 1989, a corporation could transfer its securities in exchange for money or property in the same way as its stock to one or more persons who thereafter controlled the corporation without the recognition of gain or loss. However, after October 2, 1989, the receipt of securities is treated as property received and gain is recognized.

Assumption of liability. If, in return for stock, securities, or other property, you transfer to a corporation property subject to a liability, or if the corporation assumes your liabilities, the assumption or transfer (in the amount of the liabilities) is considered as money received by you for purposes of determining your basis.

Basis of Property Transferred

The basis of property that a corporation receives from you in exchange for its stock in an 80% control transaction, or as paid-in surplus, or as a contribution to capital where no gain or loss is recognized by you is the same basis you had in the property. If you receive other property or cash in addition to the corporation stock, and you recognize a gain, the basis of the property to the corporation is the same as it was to you, increased by any gain you recognize on the exchange.

If a corporation receives property by issuing stock for it, other than in an 80% control transaction, the basis of the property to the corporation is usually the fair market value of the stock at the time of the exchange. If the stock has no established value, evidence of the fair market value of the transferred property may be used to set the value of the stock if all outstanding stock is issued in exchange for that property.

Start-Up Expenses

No deduction is allowed for start-up expenses unless the corporation chooses to treat those expenses as deferred expenses and to amortize them. When you amortize start-up expenses, deduct them in equal amounts over a period of not less than 60 months. The amortization period starts in the month the active business is started or acquired.

A start-up expense is one that you pay or incur for creating an active trade or business, or for investigating the possibility of creating or acquiring an active trade or business. However, to be amortizable, it must have been deductible if paid or incurred in connection with the expansion of an existing trade or business in the same field. Amounts paid or incurred in connection with any activity engaged in for profit and for the production of income, paid before the day the active trade or business begins and in anticipation of the activity becoming an active trade or business, are considered start-up expenses. Start-up expenses should not be confused with organizational expenses, which are discussed later.

Start-up expenses are those you have before you actually begin business operations. They include expenses both for investigating a prospective business and getting the business started. For example, what you pay for the following would count as start-up expenses if you paid or incurred them before your business started operation.

- A survey of potential markets,
- An analysis of available facilities, labor supply, etc.,
- Advertisements for the opening of your business,
- Salaries and wages for employees who are being trained, and for their instructors,
- Travel and other necessary expenses for lining up distributors, suppliers, or customers, and
- Salaries and fees for executives, consultants, or for other professional services.

Start-up expenses do not include interest, taxes, or research and experimental expenses that are allowable as deductions.

Choosing to amortize. If you want to amortize start-up expenses, attach a statement to the corporation's tax return for the tax year in which the amortization period starts. The statement should say that you are choosing to amortize start-up expenses. It should also show the total amount of those expenses and describe what they were for, the date incurred, the month the corporation began its business, and the number of months in the amortization period (not less than 60). The return and statement must be filed by the due date of the return (including any extensions of time).

Organizational Expenses

A newly organized corporation may choose to deduct its organizational expenses in equal monthly amounts over a period of not less than 60 months starting with the first month the corporation is actively engaged in business. If the choice is not made, these expenses must be capitalized and may be deducted only in the year the corporation is finally liquidated. These expenses must be incurred before the end of the first tax year the corporation is in business.

Organizational expenses are those directly connected with the creation of the corporation that would be chargeable to the capital account. If spent in connection with the creation of a corporation having a limited life, the expenses are amortizable over that limited life. They include expenses of temporary directors and of organizational meetings of directors or shareholders, fees paid to a state for incorporation, and accounting expenses and legal services incident to organization, such as drafting the charter, bylaws, minutes of organizational meetings, and terms of the original stock certificates.

Expenses for issuance or sale of stock. Expenses for issuance or sale of stock or securities, such as commissions, professional fees, and printing costs, cannot be deducted or amortized. Nor can expenses connected with the transfer of assets to the corporation be deducted or amortized.

Time and manner of choosing. If a corporation wants to amortize organizational expenses, it must choose to do so when it files its return for the first tax year it is actively engaged in business. The choice must be made not later than the due date (including extensions) of the return for that tax year. The corporation does this by attaching a statement to its return indicating that it chooses to amortize these expenses.

The statement should show the description and amount of the expenses, the date incurred, the month the corporation began business, and the number of months (not less than 60) over which the expenses are to be deducted. The time over which the corporation chooses to amortize its organizational expenses is binding.

Start of business. A corporation starts business when it starts the activities for which it was organized. Generally, this occurs after its charter is issued. However, a corporation is considered to have begun business if its activities reach the point necessary to establish the nature of its business operations, even though it may not have received its charter. For example, if a corporation acquires the assets necessary to operate its business, it may be considered to have begun business activities.

Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, there are special provisions that apply to corporations.

Below-Market Loan

If a corporation issues a shareholder or an employee a below-market loan, the corporation

will have to report additional income. The borrower may be entitled to claim an interest deduction in excess of any interest that may actually have been paid or incurred.

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which the lender is deemed (1) to have made a loan to the borrower in exchange for a note that requires payment of interest at the applicable federal rate, and (2) to have made a payment to the borrower. The lender's payment to the borrower is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

See Publication 535, *Business Expenses*, for more information on below-market loans.

Transfer of Stock

If a corporation transfers stock to a creditor in satisfaction of its indebtedness, the corporation is treated as satisfying the indebtedness with money equal to the fair market value of the stock. Therefore, the corporation will have income from discharge of indebtedness to the extent the debt exceeds the value of the stock. This rule does not apply if the discharge occurs under a title 11 bankruptcy case, or to the extent the debtor is insolvent.

Golden Parachute Payments

Corporations may enter into "golden parachute" contracts with key personnel. Under a typical golden parachute contract, the corporation agrees to make payments to certain officers, shareholders, or highly compensated individuals in the event of a change in the ownership or control of the corporation, or in the event of a change in the ownership of a substantial portion of the corporation's assets.

If the aggregate present value of the payments to any officer, shareholder, or highly compensated individual equals or exceeds three times the recipients' base amount, the excess of any parachute payment over the portion of the base amount allocated to the payment is not deductible. The ***base amount*** is the average annualized includible compensation which was payable to the recipient by the corporation during the 5 taxable years ending before the date of the change in ownership or control. Furthermore, a nondeductible excise tax of 20% of these payments is imposed on the recipient in addition to regular income tax. For more information, see section 280G of the Internal Revenue Code.

Adjustments—Tax Preferences

Some items of income and deduction, called adjustments or tax preference items, are given special treatment under the tax laws and may result in an additional tax called the alternative minimum tax (discussed later). The following items must be adjusted before they are taken into account in determining a corporation's taxable income:

- ***Section 1250 capital gain treatment.*** In the case of section 1250 property that is disposed of during the tax year, 20% of any excess of (a) the amount that would be ordinary income if the property was section 1245 property over (b) the amount treated as ordinary income under section 1250 is treated as ordinary income under section 1250 and will be recognized.

  Section 1250 property. This includes all real property that is subject to an allowance for depreciation and is not or has never been section 1245 property.

  Section 1245 property. This includes any property that is or has been subject to an allowance for depreciation and is personal property (both tangible and intangible), and certain other property.

  See Publication 544, *Sales and Other Dispositions of Assets*, for more information on these kinds of property.

- ***Percentage depletion.*** In the case of iron ore and coal (including lignite), the amount allowable as a percentage depletion deduction is reduced by 20% of any excess of (a) the amount of the percentage depletion deduction allowable for the tax year (determined without this adjustment), over (b) the adjusted basis of the depletable property at the close of the tax year (figured without the depletion deduction for the tax year).
- ***Pollution control facilities.*** The amortizable basis of pollution control facilities is reduced by 20% in determining the amortization deduction for that property.
- ***Mineral exploration and development costs.*** The amount allowable as a deduction for mineral exploration and development costs is reduced by 30%. Special rules apply to the amount not allowed because of this adjustment. This reduction also applies to the ***intangible drilling costs*** of an integrated oil company.
- ***Bad debt deductions.*** These deductions for financial institutions must be reduced by 20%.

These adjustments apply to all corporations. However, they do not apply to an S corporation unless it was a C corporation for any of the 3 immediately preceding tax years.

Dividends-Received Deduction

A corporation is allowed a deduction for a percentage of certain dividends received during its tax year.

Dividends from domestic corporations. A corporation may deduct, subject to certain limitations, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the distributing corporation. Dividends on certain preferred stock of public utility companies (mentioned later), and certain Federal Home Loan Banks are treated differently. The dividends must be distributions from the earnings and profits of the paying corporation. This rule applies if the corporation owns less than 20% of the paying domestic corporation.

20%-or-more owners allowed 80% deduction. A corporation can take a deduction for 80% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. This corporation is referred to as a ***20%-owned corporation.***

Ownership. Ownership, for purposes of these rules, is determined by the amount of voting power and value of stock (other than certain preferred stock) the corporation owns.

Capital gain dividends. Capital gain dividends from a regulated investment company or real estate investment trust, and distributions that are a return of capital do not qualify for the deduction. So-called dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are treated as interest and do not qualify for this deduction.

Small business investment companies. Small business investment companies may deduct 100% of the dividends received from a taxable domestic corporation.

Affiliated corporations. Members of an affiliated group of corporations may elect, if certain conditions are met, to deduct 100% of the dividends received from a member of the same affiliated group. See section 243 of the Internal Revenue Code for the definition of an affiliated group of corporations.

Regulated investment company. Regulated investment company dividends received are subject to certain limitations. For more information, see section 854 of the Internal Revenue Code.

Dividends received on certain preferred stock. Your corporation may deduct 41.176% of the dividends it receives on certain preferred stock (issued before October 1942) of a taxable public utility. For more information, see section 244 of the Internal Revenue Code.

Dividends received from foreign corporations. A corporation may deduct a percentage of the dividends it receives from 10%-owned foreign corporations. For more information, see section 245 of the Internal Revenue Code.

No deduction allowed. No deduction is allowed for dividends received from:

A real estate investment trust;

A corporation exempt from tax either for the tax year of the distribution or the preceding tax year;

A corporation whose stock has been held by your corporation for 45 days or less, and a corporation whose stock has been held by your corporation for 90 days or less, if the stock has preference as to dividends and the dividends received on it are attributable to a period or periods totaling more than 366 days; or

Any corporation, if your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Limit on deduction for dividends. Generally, the total deduction for dividends received or accrued is limited (in the following order) to:

1) 80% of the difference between taxable income and the 100% deduction for dividends received from affiliated corporations, for dividends received or accrued from 20%-owned corporations, and
2) 70% of the difference between taxable income and the 100% deduction for dividends received from affiliated corporations, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring limit. In figuring this limit, taxable income is determined without allowance for the net operating loss deduction or the deduction for dividends received (without the deduction for dividends paid on certain preferred stock of a public utility) and without regard to any adjustment due to the nontaxable portion of an extraordinary dividend (see *Reduction in Basis of Stock*, discussed later). Taxable income is also determined without regard to any capital loss carryback to the tax year.

Effect of net operating loss. If a corporation sustains a net operating loss for a tax year, the limitation of 80% (or 70%) of taxable income does not apply. To determine whether or not a corporation has a net operating loss, the dividends-received deduction is figured without regard to the 80% (or 70%) of taxable income limitation.

Example 1. A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Therefore, its taxable income is $75,000 before the deduction for dividends received. However, if it claims the full dividends-received deduction of $80,000 ($100,000 x 80%) and combines it with the operations loss of $25,000, it will have a net operating loss of $5,000. Therefore, the 80% of taxable income limitation does not apply and the corporation is entitled to a full deduction of $80,000.

Example 2. Assume the same facts as in Example 1 except that the corporation loses $15,000 from operations. Therefore, its taxable income is $85,000 before the deduction for dividends received. However, after claiming the dividends-received deduction of $80,000 ($100,000 x 80%), its taxable income is $5,000. But because the corporation will not have a net-operating loss after a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 x 80%).

Dividends received in property. When a corporation receives a dividend from another domestic corporation in the form of property other than cash, the dividend is included in income in an amount equal to the ***lesser*** of the property's fair market value ***or*** the adjusted basis of the property in the hands of the distributing corporation, increased by the amount of any gain recognized by the distributing corporation on the distribution.

Dividends received on debt-financed portfolio stock. For dividends received on debt-financed portfolio stock of domestic corporations, the 70% (80% for any dividend received from a 20%-owned corporation) dividends-received deduction is reduced by a percentage related to the amount of debt incurred to purchase the stock. This applies to stock whose holding period begins after July 18, 1984. For more information, see section 246A of the Internal Revenue Code.

Reduction in Basis of Stock

If a corporation receives an extraordinary dividend on a share of stock, and the corporation has not held the stock for more than 2 years before the dividend announcement date, the corporation's basis in the stock is reduced (but not below zero) by the nontaxed portion of the dividend. The total of nontaxed portions of dividends on a share of stock that did not reduce the basis of the stock, due to the limitation on reducing basis below zero, is treated as gain from the sale or exchange of the stock.

An ***extraordinary dividend*** is any dividend on a share of stock that equals or exceeds (1) 5% for stock that is preferred as to dividends, or (2) 10% for other stock of the corporation's adjusted basis in the share of stock. All dividends received that have ex-dividend dates within an 85-consecutive-day period are treated as one dividend. All dividends received that have ex-dividend dates within a 365-consecutive-day period are treated as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock. Qualifying dividends, discussed earlier under *Affiliated corporations*, are not included in the definition of extraordinary dividends.

If a corporation establishes, to the satisfaction of the Internal Revenue Service (IRS), the fair market value of a share of stock as of the day before the ex-dividend date, the corporation may elect to determine whether the dividend is extraordinary by using the fair market value of the stock rather than its adjusted basis. (See Revenue Procedure 87-33, 1987-2 C.B. 402.)

The ***nontaxed portion*** is the amount of any dividends-received deduction allowable on such dividends.

The ***dividend announcement date*** is the date the corporation declares, announces, or agrees to either the amount or the payment of the dividend, whichever is earlier.

Stock issued after July 10, 1989. The rules apply to an extraordinary dividend on disqualified preferred stock issued after July 10, 1989, without regard to the period the corporation held the stock.

Disqualified preferred stock. Disqualified preferred stock is any stock that is preferred as to dividends if:

1) The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future,
2) The issue price of the stock exceeds its liquidation rights or stated redemption price, or
3) The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless issued under a written binding contract in effect on that date and thereafter before the stock is issued.

Charitable Contributions

A corporation may claim a deduction, subject to certain limits, for any charitable contributions made in cash or other property. To be deductible, the contribution generally must be made to or for the use of community chests, funds, foundations, corporations, or trusts organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, or other charitable organizations.

A deduction will not be allowed if any of the net earnings of an organization that receives the contribution are used for the benefit of any private shareholder or individual.

Cash method corporation. A corporation using the cash method of accounting may deduct contributions only in the year paid.

Accrual method corporation. A corporation using the accrual method of accounting may choose to deduct contributions authorized by the board of directors, but not paid during the tax year, if payment is made within 2½ months after the close of the tax year. The choice must be made by reporting the contribution on the corporation return for the tax year. The return must be accompanied by a declaration stating that the resolution authorizing the contribution was adopted by the board of directors during the tax year for which the return is filed. This declaration must be signed by the president or another principal officer. A copy of the resolution authorizing the contribution must also be attached to the return.

Limit. Your corporation may not deduct contributions that total more than 10% of its taxable income. Taxable income for this purpose is figured ***without*** taking into account the following:

Deduction for contributions;

Deductions for dividends received and dividends paid;

Any net operating loss carryback to the tax year; and

Any capital loss carryback to the tax year.

Carryover of excess contributions. Any charitable contributions made during the year that are more than the 10% limit may, subject to certain restrictions, be carried over to each of the following 5 years. Any excess not used up within that period is lost. Thus, if a corporation has a carryover of excess contributions paid in 1989 and the excess is not completely used up in filing its return for 1990, it may be carried over to 1991, 1992, 1993, and 1994. A carryover of excess contributions is not deducted in the carryover year until after any contributions made in that year (subject to the 10% limit) have been deducted. A carryover of excess contributions is not allowed to the extent that it increases a net operating loss carryover in a suceeding tax year.

Capital Losses

A corporation, other than an S corporation, may deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has a net capital loss, the loss cannot be deducted in the current tax year. It must be carried to other tax years and deducted from capital gains that occur in those years.

A net capital loss is first carried back 3 years. It is deducted from any total net capital gain which occurred in that year. If the loss is not completely used up, it is carried forward 1 year (2 years back) and then 1 more year (1 year back). If it is still not used up, it is carried over to future tax years, 1 year at a time, for up to 5 years. When a net capital loss is carried to another tax year, it is treated as a short-term loss. It does not retain its original identity as long term or short term.

Example. In 1990, a corporation has a net short-term capital gain of $3,000 and a net long-term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. This $6,000 is treated as a short-term loss when carried back or forward.

In 1987, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. The $6,000 short-term loss that is carried back from 1990 is subtracted first from the net short-term gain. This results in a net capital gain for 1987 of $7,000, consisting of a net short-term capital gain of $2,000 ($8,000 minus $6,000) and a net long-term capital gain of $5,000.

S corporation status. A capital loss may not be carried back from, or to, a year in which the corporation had in effect an election to be treated as an S corporation.

Rules for carryover and carryback. When carrying a capital loss from 1 year to another, the following rules apply:

When figuring this year's net capital loss, you cannot use any capital loss carried from another year. In other words, you may only carry capital losses to years that would otherwise have a total net capital gain.

If capital losses from 2 or more years are carried to the same year, the loss from the earliest year is deducted first. When that loss is completely used up, the loss from the next earliest year is deducted, and so on.

A capital loss carried from another year cannot be used to produce or increase a net operating loss in the year it is carried to.

Foreign expropriation losses. A corporation may not carry back foreign expropriation capital losses. However, these losses may be carried over for up to 10 future tax years. They will be treated as short-term capital losses in each year they are carried to.

Refunds. When you carry back a capital loss to an earlier tax year, you must refigure your tax for that year. If you find your corrected tax is less than you originally owed, you may apply for a refund. File Form 1120X, *Amended U.S. Corporation Income Tax Return.*

Related Taxpayers

The related party rules apply to transactions between an individual and a corporation that the individual controls. They apply to sales or exchanges of property and the deduction of certain unpaid business expenses and interest.

The related party rules include two corporations that are members of the same controlled group, a partnership and a corporation owned by the same person, and an S corporation and a C corporation if owned by the same person. In addition, losses on the sale or exchange of property between members of the same controlled group of corporations are deferred rather than denied. Under certain conditions, the IRS may reallocate income and deductions between two or more businesses that are either directly or indirectly controlled by the same interests.

For an explanation of these tax rules and their operation, see Publication 535, *Business Expenses;* Publication 537, *Installment Sales;* and Publication 544, *Sales and Other Dispositions of Assets.*

Accrual basis corporation. An accrual basis taxpayer cannot deduct expenses owed to a related cash basis person until payment is made, and the amount is includible in the gross income of the person paid. This rule applies even if the relationship ceases before the amount is includible in the gross income of the person paid.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related parties does not apply either to any loss of a distributing corporation or to any loss of a distributee in the case of a distribution in complete liquidation.

Interest paid to related parties. A deduction for interest paid by a corporation to related parties not subject to tax on the interest received is limited to the extent this interest exceeds 50% of the corporation's pre-net-interest-deduction taxable income. The amount of disallowed interest is carried over to subsequent years.

This interest deduction limitation applies to a corporation that has ***excess interest expense*** and whose ratio of debt to equity as of the close of the tax year exceeds 1.5 to 1.

Excess interest expense. Excess interest expense is the excess of the corporation's net interest expense over the sum of 50% of the corporation's adjusted taxable income plus any ***excess limitation*** carryforward.

Excess limitation. Excess limitation means the excess of 50% of the corporation's adjusted taxable income over the corporation's net interest expense.

If a corporation has an excess limitation for a tax year, that amount becomes an excess limitation carryforward to the first succeeding tax year. When it is not used up in the first tax year, it is carried forward to the second or third succeeding tax year if it is not used up before then.

"Not subject to tax on the interest" means that the related party is not subject to U.S. income tax on the interest income. For example, the related party may be a foreign parent corporation not subject to U.S. tax.

Net Income or Loss

At the end of each tax year, a corporation must figure its net income or loss. To do this, the operating expenses and other allowable deductions are subtracted from its gross income. The corporation's tax is then figured as explained under *Figuring the Tax.*

The at-risk rules apply to closely held corporations that are engaged in any activity as a trade or business or for the production of income. These rules limit a corporation's loss.

Generally, the at-risk rules do not apply to a qualifying business that is an active business of a qualified corporation (other than an S corporation). For more information on the at-risk rules, see Publication 925, *Passive Activity and At-Risk Rules.*

Figuring the Tax

Corporate taxable income is subject to tax under the following three-bracket graduated rate system:

Taxable Income	Tax Rate
Not over $50,000	15%
Over $50,000 but not over $75,000	25%
Over $75,000	34%

An additional 5% tax, up to $11,750, is imposed on corporate taxable income over $100,000. Corporations with taxable income of at least $335,000 pay a flat rate of 34%.

Controlled group of corporations. A controlled group of corporations is limited to one apportionable $50,000 amount and one $25,000 amount (in that order) in each taxable income bracket below 34%.

The use of only one apportionable $50,000 and $25,000 (in that order) amount for each taxable income bracket is required for a controlled group of corporations. For more information, see sections 1561 and 1563 of the Internal Revenue Code.

Attribution rules. In determining whether a corporation is a member of a controlled group of corporations, you must also apply the attribution rules for partnerships, trusts, and estates.

Personal service corporations. The taxable income of a qualified personal service corporation is taxed at a flat rate of 34%. These corporations cannot use the graduated tax rates that apply to other corporations.

A corporation is a ***qualified personal service corporation*** if:

- At least 95% of the value of its stock is held by employees, or their estates or beneficiaries, and
- Its employees perform services at least 95% of the time in any of the following fields:
  - Health,
  - Law,
  - Engineering,
  - Architecture,
  - Accounting,
  - Actuarial science,
  - Performing arts, or
  - Consulting.

Credits

The tax liability of a corporation is ***decreased*** by credits, such as:

1) Credit for fuels and lubricants used for certain purposes (see Publication 378, *Fuel Tax Credits and Refunds*);
2) Foreign tax credit (use Form 1118);
3) General business credit (use Form 3800);
4) Orphan drug credit (use Form 6765);
5) Possessions tax credit (use Form 5735); and
6) Credit for fuel produced from a nonconventional source.

General business credit. The investment credit, jobs credit, alcohol fuel credit, research credit, and the low-income housing credit are combined into one credit called the "general business credit." These credits are separately figured on the appropriate form:

- ***Form 3468,*** *Investment Credit,*
- ***Form 5884,*** *Jobs Credit,*
- ***Form 6478,*** *Credit for Alcohol Used as Fuel,*
- ***Form 6765,*** *Credit for Increasing Research Activities (or for claiming the orphan drug credit),* and
- ***Form 8586,*** *Low-Income Housing Credit.*

Form 3800. If you have, in any tax year, more than one of these five business credits, or a carryforward or carryback of any of these credits (or a carryforward of an Employee Stock Option Plan credit), complete Form 3800, *General Business Credit,* to figure your general business credit and file it with your tax return. However, if you have only one of these credits and no carrybacks or carryovers, you should not file Form 3800. In that case, file the individual tax form relating to the credit.

See the instructions to Form 3800 for more information.

Other Taxes

The tax liability of a corporation is ***increased*** by:

1) Personal holding company tax (attach Schedule PH (Form 1120));
2) Investment credit recapture;
3) Alternative minimum tax; and
4) Environmental tax.

Environmental tax. A corporation is liable for a tax equal to .12% of the excess of modified alternative minimum taxable income for the year over $2,000,000. This tax will not apply after 1991. This tax also must be considered when determining your 1991 estimated tax.

Modified alternative minimum taxable income. Modified alternative minimum taxable income is alternative minimum taxable income (defined later under *Alternative Minimum Tax*) without regard to the alternative tax net operating loss deduction and the deduction for the environmental tax.

Alternative Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. So that taxpayers (including corporations) who benefit from these laws will pay at least a minimum amount of tax, a special tax has been enacted—the "alternative minimum tax" for corporations and individuals.

The rules discussed in this section of the publication apply to corporations. The alternative minimum tax that applies to individuals is discussed in Publication 909, *Alternative Minimum Tax for Individuals.*

An alternative minimum tax for corporations, similar to the alternative minimum tax for individuals, replaces the minimum tax under prior law. The rate is 20%, and there is a $40,000 exemption amount that is reduced (but not below zero) by 25% of the amount by which alternative minimum taxable income exceeds $150,000.

A minimum tax credit is allowed against your regular tax liability in subsequent years for the alternative minimum tax that is attributable to certain preferences and adjustments. You must consider your alternative minimum tax when determining your 1991 estimated tax.

Figure the alternative minimum tax as follows: Begin with ***taxable income before net operating loss deduction*** on the return (line 28 minus line 29b on Form 1120; and line 24 minus line 25b on Form 1120–A).

Add or Subtract

Adjustments, to taxable income

Add

Tax preferences

Equals

Alternative minimum taxable income

Subtract

Exemption amount

Multiply by

20%

Subtract

Foreign tax credit

Equals

Tentative minimum tax

Subtract

Regular tax

Equals

Alternative minimum tax

Who Must Pay Alternative Minimum Tax

Corporations may have to pay the alternative minimum tax if taxable income for regular tax purposes, plus any of the adjustments and preference items that apply, totals more than $40,000. The adjustments and preference items are as follows:

Adjustments	Descriptions
Accelerated depreciation on new property	Depreciation used for alternative minimum tax is figured under the alternate modified accelerated cost recovery system (MACRS), except that for personal property the 150% declining balance method is used
Mining exploration and development costs	Allowable costs must be amortized ratably over 10 years
Long-term contracts	For contracts entered into after February 28, 1986, figure income under the percentage of completion method
Pollution control facilities	Amortization is figured under alternate MACRS
Certain installment sales	Installment method generally does not apply for alternative minimum tax
Circulation expenses	Expenditures must be amortized ratably over 3 years (for personal holding companies only)
Merchant Marine fund	Amounts deposited in capital construction funds are not deductible, and earnings on amounts in the fund are not excludable
Basis adjustments	Gain or loss on the sale of property is refigured taking into consideration certain adjustments listed in this table
Certain loss limitations	The excess, if any, of the recomputed loss over the loss reported for regular tax purposes
Passive activity losses	Net losses from passive activities (closely held and personal service corporations only), including tax shelter farm activities (personal service corporations only), not allowed
Adjusted current earnings (ACE)	Adjustment is 75% of the excess of the corporation's ACE over the corporation's preadjustment AMTI for tax years beginning after 1989.
Net operating losses	NOL deduction allowed against alternative minimum taxable income, but cannot offset more than 90%

Tax Preferences	Descriptions
Accelerated depreciation on depreciable real property and depreciable leased personal property placed in service before 1987 (pre-ACRS and pre-MACRS property)	Excess of depreciation or amortization taken over straight-line deduction (leased personal property: for personal holding companies only)
Pollution control facilities before 1987	Excess of amortization over depreciation otherwise allowed
Depletion	Excess of depletion deduction over adjusted basis in property
Intangible drilling costs	If you elect the optional 60–month write-off, IDCs are not a tax preference item. IDCs are a tax preference item to the extent that excess IDCs exceed 65% of the net income from the property.
Certain tax-exempt interest	Certain interest on specified private activity bonds
Appreciated property charitable deduction	Unrealized appreciation on donated long-term capital gain property
Reserves for losses on bad debts of financial institutions	Excess of deduction over amount allowed under the experience method

Form 4626. Use Form 4626, *Alternative Minimum Tax—Corporations*, to figure the corporation's alternative minimum tax. This form must be filed if the corporation's taxable income plus adjustments and tax preference items totals more than $40,000. This form may also be used to figure the corporation's environmental tax, discussed earlier.

Alternative Minimum Taxable Income

To figure the alternative minimum tax, you must first arrive at alternative minimum taxable income. Begin with taxable income before the net operating loss deduction shown on the tax return (line 28 minus line 29b on Form 1120; and line 24 minus line 25b on Form 1120–A). Combine that with the adjustments discussed next, and the preference items discussed later.

If there is a net operating loss deduction, figure a separate limit on the amount that can be claimed. There is also a separate computation, if applicable, for the adjusted net book income of the corporation.

Note: If a corporation's tax base is measured by something other than taxable income, such as real estate investment trust taxable income or life insurance company taxable income, alternative minimum taxable income is determined using that tax base.

Adjustments to Taxable Income

To figure the alternative minimum taxable income, certain adjustments must be made to the taxable income shown on the return. These adjustments are designed to eliminate the tax advantages of items that receive preferential tax treatment. The amount of the adjustment is generally the difference between the recomputed item and the amount shown on the return. They can be either increases or decreases.

Accelerated depreciation. For property placed in service before 1987, accelerated depreciation was a tax preference item. Continue to treat depreciation on that property as a preference item. See *Accelerated depreciation on real property placed in service before 1987* and *Accelerated depreciation on leased personal property placed in service before 1987*, discussed later under *Tax Preference Items*.

Depreciation of property placed in service after 1986. The depreciation deduction used in computing alternative minimum taxable income is the amount calculated under the alternate modified accelerated cost recovery system (MACRS). For real property, use the straight-line method with a 40–year recovery period and the mid-month convention. For most property other than real property, use the 150% declining balance method switching to the straight-line method when it results in a larger allowance. The adjustment applies to real and personal property placed in service after 1986, other than transition property. It also applies to property placed in service after July 31, 1986, and before 1987 if you elected the MACRS.

The following types of property are not considered in figuring this adjustment item:

- Property you elect to exclude from MACRS that is depreciated under the unit-of-production method or most other methods of depreciation not expressed in terms of years;
- Certain public utility property;
- Any motion picture film or video tape; or
- Any sound recording.

The adjustment is the difference between the total depreciation for all property for alternative minimum tax purposes and the total depreciation for regular income tax purposes.

The effect of using two different types of depreciation (one for regular income tax and one for alternative minimum tax) is that a corporation will have a different basis in the property for alternative minimum tax. This means, for example, that if a corporation sell the property, the gain will be different for alternative minimum tax purposes. See the later discussion of *Basis adjustment*.

For more information on depreciation, see Publication 534, *Depreciation*.

Circulation costs. This adjustment is for personal holding companies only. In figuring alternative minimum taxable income, circulation costs must be amortized over 3 years beginning with the tax year in which the expenditures were made. The adjustment is the difference between the

amount deducted for regular tax purposes and the refigured amortization.

Mining exploration and development costs. This deduction is computed by taking the amount you are allowed as a deduction for regular tax purposes for mining exploration and development costs, and amortizing it ratably over a 10–year period. The adjustment is the difference between the deduction claimed for regular tax and the deduction allowed for alternative minimum tax.

If a loss is sustained for mining property (that is, the mine is abandoned as worthless), in figuring alternative minimum taxable income, you can deduct all mining exploration and development costs relating to the property that have not yet been written off.

Long-term contracts. In the case of any long-term contract you enter into after February 28, 1986, the completed contract method of accounting, or certain other methods of accounting for long-term contracts, are not allowable. Instead, you are required to apply the percentage of completion method (as modified by the rules for long-term contracts under section 460 of the Internal Revenue Code) in determining alternative minimum taxable income relating to that contract.

The adjustment is the difference between income determined using the method of accounting used for regular tax purposes and income determined using the percentage of completion method of accounting, plus any other applicable adjustment. If the refigured taxable income is less, show the adjustment as a negative amount.

Home construction contracts. The rules for long-term contracts do not apply to:

1) Any home construction contract you entered into after June 20, 1988, with respect to which you meet the ***small home construction contract*** requirements (see section 460(e) of the Internal Revenue Code), or
2) Any home construction contract you entered into in a tax year beginning after September 30, 1990, regardless of whether you meet the small home construction contract requirements.

For a contract described in (1) the percentage of the contract completed is to be determined using the simplified procedures for allocating costs (see IRC section 460(b)(4)).

Amortization of certified pollution control facilities. For purposes of the alternative minimum tax, your amortization deduction for a certified pollution control facility placed in service after 1986 is determined under the alternate MACRS rule (see Publication 534). Also see *Amortization of certified pollution control facilities (before 1987)*, discussed later under *Tax Preference Items*.

Installment sales of certain property. In the case of any disposition of inventory or stock in trade, the installment method of accounting does not apply for purposes of the alternative minimum tax. Therefore, a corporation is required to recognize all gain realized on the disposition in the year of sale. The adjustment is the difference between the recognition of all gain in the year of disposition and the amount of gain recognized under the installment method of accounting. For years in which the sale proceeds are actually collected, the regular taxable income must be decreased to arrive at the alternative minimum taxable income.

Repeal. The installment method of accounting is repealed (for regular tax purposes) for dealer dispositions occurring after 1987. However, for regular tax purposes, a dealer disposition does not include:

1) The disposition of property used or produced in the trade or business of farming, or
2) Certain dispositions of timeshares or residential lots for which you elected to pay interest.

Item (2) applies for alternative minimum tax purposes only. Therefore, no adjustments are normally necessary for dealer dispositions occurring after 1987, although they are still possible.

Basis adjustment. If a corporation sold property during the year, you must refigure the gain or loss from the sale using the corporation's adjusted basis for alternative minimum tax purposes. The following alternative minimum tax adjustments will require changes to the corporation's regular tax basis:

Depreciation;

Circulation expenses;

Mining exploration and development costs; and

Pollution control facilities.

Enter on line 2e of Form 4626, the difference between the gain (or loss) reported on the corporation's return for regular tax purposes and the recomputed gain (or loss) for alternative minimum tax purposes.

Certain loss limitations. You must take into account the corporation's alternative minimum tax adjustments and preferences before you apply certain loss deferral rules.

The loss deferral rules include limits on losses due to:

A partner's basis in the partnership interest; and

The at-risk limits.

The adjustment is the difference between the allowable loss reported for regular tax purposes and the corporation's recomputed allowable loss. This figure could be negative if the recomputed allowable loss is more than the allowable loss reported for regular tax purposes.

Tax shelter farm loss. This adjustment applies to personal service corporations only. In figuring alternative minimum taxable income, no loss from a tax shelter farm activity is allowed. Generally, a tax shelter farm activity is any farming syndicate or other passive farm activity. The loss from a tax shelter farm activity is allowed in figuring alternative minimum taxable income for later years as a deduction against income from the activity or for the year you dispose of the corporation's entire interest in the activity.

The amount of the loss that is disallowed is reduced by the amount by which a corporation is insolvent as of the end of the tax year. A corporation is insolvent to the extent that its liabilities exceed the fair market value of its assets.

Passive activity loss. This adjustment applies to closely held and personal service corporations only. To determine the adjustment for a passive activity loss, refigure the loss taking into account the corporation's alternative minimum tax adjustments and preferences. Use a separate Form 8582, *Passive Activity Loss Limitations*, to refigure the loss. The passive activity phase-in rules do not apply for alternative minimum tax purposes. The adjustment is the difference between the allowable loss reported for regular tax and the refigured allowable loss.

The amount of the loss that is disallowed is reduced by the amount by which a corporation is insolvent as of the end of the tax year. A corporation is insolvent to the extent that its liabilities exceed the fair market value of its assets.

Capital construction funds of shipping companies. Deposits into a capital construction fund established under section 607 of the Merchant Marine Act of 1936 are not deductible, and its earnings (including gains and losses) on amounts in the fund are not excludable in determining alternative minimum taxable income. No reduction in basis required by section 607(g) of the Merchant Marine Act of 1936 should be made for amounts withdrawn from the fund if the amounts have previously been included in alternative minimum taxable income.

Alternative tax net operating loss deduction. You must figure the corporation's alternative tax net operating loss deduction. The rules covering years after 1986 are discussed first. For the rules covering carryover of pre-1987 net operating losses, see *Carrybacks and carryovers*, later.

Figuring alternative tax net operating losses after 1986. For alternative minimum tax purposes, figure a net operating loss for a tax year beginning after 1986 in generally the same manner as for regular tax, except:

- Make the alternative minimum tax adjustments (discussed earlier) to the net operating loss that you figured for regular tax purposes; and
- Reduce the net operating loss by the tax preference items for such year (discussed later) except for charitable contributions of appreciated property to the extent the tax preference item increased the net operating loss for the tax year.

Carrybacks and carryovers. After making the above calculations, the amount of the net operating loss that you may deduct in a carryback or a carryover year may not exceed 90% of the corporation's alternative minimum taxable income for that year, as figured before the net operating loss deduction.

You may carry back the net operating loss 3 years or carry it forward 15 years. This is the same as under the regular NOL rules. However, if you elect not to use the carryback of an NOL for regular tax purposes, you may ***not*** carry it back for alternative minimum tax purposes.

In years that a corporation does not have an alternative minimum tax liability, you must still limit the net operating loss deduction to 90% of the corporation's "alternative minimum taxable income" for that year. Use Form 4626 to figure alternative minimum taxable income even though the corporation does not have an alternative minimum tax liability.

Figuring the amount of pre-1987 carryovers. The amount of a net operating loss carryforward from tax years beginning before 1987 that you may carry to tax years beginning after 1986 is the amount of your regular net operating loss carryover. An adjustment is required if the corporation had as deferred add-on minimum tax liability for a year before 1987. See section 701(f)(2)(B) of PL 99–514 (10/22/86).

Adjusted current earnings (ACE). For tax years beginning after 1989, corporations must increase their alternative minimum taxable income (AMTI) by the adjustment for ACE. This adjustment is equal to 75% of the excess, if any, of the corporation's ACE for the tax year over the corporation's pre-adjustment AMTI. Pre-adjustment AMTI is the corporation's AMTI for the tax year determined without the adjustment for ACE and without the alternative tax net operating loss deduction. A negative adjustment is allowed for 75% of any excess pre-adjustment AMTI over ACE to the extent of the net positive adjustments for ACE in prior tax years.

ACE is the corporation's pre-adjustment AMTI for the tax year determined by taking into account certain specified adjustments. Some of these adjustments are discussed next.

- The ***alternative MACRS depreciation system*** is used for property placed in service after 1989. This system requires use of the straight-line method over a recovery period.
- ***Intangible drilling costs.*** These costs are capitalized and amortized over a 60–month period beginning with the month the costs were paid or incurred.
- ***Depletion.*** This is computed using the cost depletion method for property placed in service after 1989.

- ***Circulation and organizational expenses.*** These expenses are not amortizable.
- ***Installment sales.*** These sales are figured without the use of the installment method.

See the instructions to line 5 of Form 4626 for more information on the ACE computation.

Tax Preference Items

Tax preference items are other income items and deductions that receive special treatment under the tax laws. They must be added back to the taxable income shown on your return in figuring a corporation's alternative minimum taxable income.

Accelerated depreciation on real property placed in service before 1987. This tax preference item is the depreciation or amortization a corporation took during the year on real property placed in service before 1987, minus the depreciation the corporation would have been allowed under the straight-line method. Figure this amount separately for each separate item of property. Generally, each building (or its component) is a separate item of property. Do not figure this tax preference for an item of property in the year that you dispose of it.

For property a corporation depreciates as 15–year real property under the accelerated cost recovery system (ACRS), figure straight-line depreciation using a recovery period of 15 years and no salvage value. However, if the actual recovery period is longer than 15 years, you will not have a tax preference item.

For property depreciated as 18–year real property under ACRS, figure straight-line depreciation using a recovery period of 18 years and no salvage value. For property a corporation is depreciating as 19–year real property under ACRS, figure straight-line depreciation using a recovery period of 19 years and no salvage value.

For property a corporation placed in service between August 1, 1986, and December 31, 1986, and elected to depreciate under the modified accelerated cost recovery system (MACRS), generally figure straight-line depreciation using a recovery period of 40 years. The MACRS is explained in Publication 534.

For property depreciated under another method, figure straight-line depreciation using the same basis, useful life, and salvage value that was first used to depreciate the property. If the corporation did not use a useful life or salvage value, the useful life or salvage value for straight-line depreciation is the one that would have been proper if it had actually taken depreciation under the straight-line method.

If a corporation amortizes rehabilitation expenses for low-income rental housing or a certified historic structure, the way you figure straight-line depreciation depends on whether you would have otherwise depreciated the corporation's rehabilitation expenses under ACRS. If the rehabilitated property would have qualified for ACRS, use a 15–year recovery period to figure straight-line depreciation. If the property would not have qualified for ACRS, figure the straight-line depreciation that would have been allowed had the corporation not claimed rapid amortization.

Accelerated depreciation on leased personal property placed in service before 1987. This tax preference item is the depreciation or amortization a corporation took during the tax year on personal property it leased to others minus the depreciation or amortization it would have been allowed to take if it used the straight-line method.

This is a tax preference item only if the corporation is a personal holding company.

Placed in service between August 1, 1986, and December 31, 1986. For leased personal property a corporation elects to depreciate under MACRS, figure the depreciation under the 150% declining balance method (switching to the straight-line method when it results in a larger allowance).

Amortization of certified pollution control facilities (before 1987). A corporation's amortization deduction for a certified pollution control facility placed in service before 1987, minus the depreciation deduction that would normally be allowed, is a tax preference item. However, it is not a tax preference for the year in which the corporation disposes of the facility.

Note: The depreciation normally allowed may be more than straight-line depreciation and thus itself may result in an item of tax preference explained under *Accelerated depreciation on real property placed in service before 1987*, above. However, to the extent that the amortization deduction is treated as a preference item under this paragraph, it is not an item of tax preference under the above item.

Placed in service after 1984. To figure its amortization deduction for a pollution control facility placed in service after 1984, a corporation must reduce its basis in the facility by 20%. Then, to figure its tax preference item for this deduction, it takes 59¾% of the difference between the amortization deduction (figured using this reduced basis) and the depreciation deduction that would otherwise be allowed.

Example. The Feather Corporation placed a certified pollution control facility in service on January 1, 1986, at a cost of $1,000,000 and chose to amortize the facility over 60 months. When figuring the amortization, the basis of the facility was reduced by $200,000 (20% of $1,000,000). Feather's deduction for amortization in 1986, 1987, 1988, and 1989 was $160,000 ($800,000 × 12 months/60 months). The same amount of $160,000 is deducted in 1990. The facility is 19–year real property and was placed in service at the beginning of Feather's 1986 tax year. The depreciation deduction that would have been allowed under ACRS for 1990 is 6.3% of $1,000,000, or $63,000. The excess amortization is $97,000 ($160,000 minus $63,000), and the amount treated as a tax preference is $58,038 (59¾% of $97,000).

Placed in service after 1982 and before 1985. To figure the tax preference item for a pollution control facility placed in service after 1982 but before 1985, follow the steps under *Placed in service after 1984*, substituting 15% for 20% and 71.6% for 59¾%.

Percentage depletion. If a corporation's depletion deduction for the year is more than its adjusted basis in the property at the end of the year (figured before reducing the basis by the depletion deduction), the difference is a tax preference item. This preference item should be figured separately for each separate piece of property being depleted.

Percentage depletion of coal and iron ore. Figure a corporation's (other than an S corporation's) tax preference for the percentage depletion of coal (including lignite) and iron ore as follows:

1) Subtract the corporation's basis in the property at the end of the year (before adjusting it for the year's depletion) from the year's percentage depletion on the property.
2) Reduce the corporation's percentage depletion by 20% of the amount figured in (1). This is the most the corporation can deduct for percentage depletion on the property.
3) Subtract the corporation's basis in the property (before adjusting it for the year's depletion) from the amount figured in (2). The result is the corporation's tax preference item for percentage depletion on the property.

Intangible drilling costs (IDCs). If you have elected the optional 60–month write-off for IDCs, these costs are not a tax preference item. In general, this tax preference item is the amount by which excess IDCs paid or incurred during the year on a corporation's oil, gas, and geothermal properties are ***more than 65%*** of the net income of these properties.

Excess IDCs. These are costs incurred or paid in connection with oil, gas, and geothermal wells over the amount that would have been allowed if the costs had been amortized using a 10–year straight-line method or any permitted cost depletion method.

Net income from oil, gas, and geothermal properties for this purpose is the gross income from all these properties over the deductions allocated to these properties. Deductions do not include excess IDCs or costs related to nonproductive wells. Nonproductive wells are those that are plugged and abandoned without ever having produced oil, gas, or geothermal energy in commercial quantities for any substantial period of time. But a well that is merely temporarily shut in is not considered a nonproductive well.

Every corporation that is an integrated oil company must reduce its deduction for intangible drilling and development costs to 70% of what it could otherwise deduct. The remaining 30% must be deducted ratably over a 60–month period, beginning with the month the costs are paid or incurred.

Bad debt deductions—financial institutions. The deduction allowed for a reasonable addition to a financial institution's reserve for bad debts minus the amount that would have been allowed based on actual loss experience is a tax preference item.

A financial institution must reduce its bad debt deduction by 20% of the amount figured in the previous sentence. It figures its tax preference item by subtracting its actual bad debt losses for the year from this reduced bad debt deduction.

Tax-exempt interest on specified private activity bonds. This tax preference item is the tax-exempt interest on private activity bonds, generally issued after August 7, 1986 (or, on or after September 1, 1986, in the case of bonds satisfying pre-Tax Reform Act of 1986 definitions of governmental bonds), reduced by expenses not allowed in computing the regular tax because they are related to tax-exempt income that would have been allowable if the obligations were not exempt.

For purposes of this tax preference item, a private activity bond does not include a qualified section 501(c)(3) bond, or any refunding bond (whether a current or advance refunding) if the refunded bond (or in case of a series of refundings, the original bond) was issued before August 8, 1986. Any exempt-interest dividends a corporation receives from a mutual fund must be separated from the total and included in this preference item. In addition, any exempt-interest dividend will be treated as interest on a specified private activity bond to the extent of its proportionate share of the interest on such bonds received by the company paying the dividend.

Charitable contributions of appreciated property. If you make a charitable contribution of appreciated capital gain property, an amount equal to the portion of the regular tax deduction claimed that exceeds the property's adjusted basis is treated as a tax preference item. For purposes of alternative minimum tax, capital gain property has the same meaning as under the rules relating to charitable deductions.

Optional Write-Off

A corporation may choose an optional 3–year or 10–year write-off of certain adjustments and preference items in figuring its regular income tax. If it does, these items will not be considered adjustments or preference items for purposes of the alternative minimum tax. A corporation may make this choice for the following items.

3-year write-off. A corporation can choose to deduct, in equal installments over a 3-year period, the cost of increasing the circulation of a newspaper or periodical.

10-year write-off. The costs a corporation can choose to deduct in equal installments over 10 years are: mining exploration and development costs; development expenses; and research and experimental expenses.

Choosing the optional write-off. Choose the optional write-off by the due date (including extensions) of the corporation's income tax return for the year for which you are making the choice. Attach to the corporation's return a statement which includes:

The corporation's name, address, and employer identification number.

The specific write-off you are choosing.

A note you are making this choice under section 59(e) of the Internal Revenue Code.

The year for which you are making the choice and the tax preference item to which it applies.

You may use Form 4562, *Depreciation and Amortization*, to choose the optional write-off. Once the optional write-off is selected with respect to any qualified expense, the choice may be revoked only with the consent of the IRS.

Figuring Alternative Minimum Tax

After you arrive at alternative minimum taxable income, figure the tax. Subtract from the corporation's alternative minimum taxable income an ***exemption amount.*** Next multiply the balance by the alternative minimum tax rate of 20%. This will be the ***tentative minimum tax.*** Subtract the corporation's ***regular tax*** from the tentative minimum tax. The result is the corporation's alternative minimum tax.

Exemption Amount

The alternative minimum tax is not intended to apply to corporations in the lower tax brackets with small amounts of adjustments or preference items. This is accomplished by subtracting an exemption amount from the corporation's alternative minimum taxable income before figuring the tentative minimum tax. The exemption amount is phased out for corporations with high income.

The maximum amount of this exemption is $40,000. However, it is reduced by $0.25 for every $1 that the alternative minimum taxable income exceeds $150,000. Thus, the exemption amount is completely phased out when the corporation's alternative minimum taxable income exceeds $310,000.

Tentative Minimum Tax

The tentative minimum tax is figured by multiplying the corporation's alternative minimum taxable income, minus the $40,000 exemption amount, by 20%. This is the tentative minimum tax unless the corporation has an alternative minimum tax foreign tax credit. If the corporation has a foreign tax credit, subtract it to arrive at the tentative minimum tax.

Foreign tax credits. A corporation's foreign tax credit is figured by first using taxable income, adjustments, and tax preference items from sources outside the United States, to arrive at alternative minimum taxable income from sources outside the United States. Then, using both this amount for taxable income from sources outside the United States and the corporation's alternative minimum taxable income for total taxable income, compute the foreign tax credit on Form 1118, *Computation of Foreign Tax Credit—Corporations.*

Limit. The alternative minimum tax foreign tax credit cannot be more than the amount on Form 4626, line 11, less 10% of the amount that would be on that line if Form 4626 were refigured using zero on line 7.

Regular Tax

After you figure the corporation's tentative minimum tax, subtract its regular tax to arrive at the alternative minimum tax. ***Regular tax*** is the corporation's income tax on Page 2, line 1, Part I, Form 1120–A; or line 3, Schedule J, Form 1120, minus any foreign tax credit (line 4a, Schedule J, Form 1120) and the possessions tax credit (line 4b, Schedule J, Form 1120).

Credits. If a corporation pays alternative minimum tax, it will not obtain any tax benefit from certain nonrefundable credits (listed below) other than the foreign tax credit. If a corporation has adjustments or preference items but does not pay alternative minimum tax because of the exemption amount, it may or may not receive any benefit from these credits.

A corporation may only claim these credits to the extent that its regular tax liability exceeds its alternative minimum tax liability. It cannot claim these credits to the extent they reduce the corporation's regular tax liability below the amount of its tentative minimum tax. Any excess credit will be allowed as a carryback or carryover under the usual rules for that credit.

The nonrefundable credits include:

Credit for fuel from a nonconventional source,

Targeted jobs credit,

Alcohol fuels credit,

Research credit, and

Low-income housing credit.

Minimum Tax Credit

A corporation may be eligible to take a minimum tax credit against its regular income tax. If a corporation paid an alternative minimum tax in 1987, 1988, or 1989 because of adjustments or preference items that defer its tax liability rather than cause a permanent avoidance of the tax, the corporation's 1987, 1988, or 1989, alternative minimum tax is available to be claimed as a credit against its regular income for 1990 and later years.

The credit is limited to the corporation's regular tax for the year to which it is carried, less the following:

1) Foreign tax credit,
2) General business credit, and
3) The tentative minimum tax for the year in which the credit is being used.

The credit the corporation is allowed to take in 1990 is based on its 1987, 1988, or 1989 net alternative minimum tax. This is the alternative minimum tax the corporation actually paid in 1987, 1988, or 1989. However, the alternative minimum tax may have to be adjusted. See the following discussion. Use Form 8801, *Credit For Prior Year Minimum Tax*, to figure the credit.

Figuring the Credit

A corporation's net minimum tax is the amount of the net minimum tax for the year increased by the credit not allowed:

1) For producing fuel from a nonconventional source due to the tentative minimum tax for the year, and
2) Clinical testing expenses for certain drugs for rare diseases or conditions due to the tentative minimum tax for the year.

Carryforward of Credit

A corporation may carry the alternative minimum tax credit forward (indefinitely) to reduce its regular tax liability in future years. If the corporation does not use all of the credit in 1990, the balance may be carried forward to 1991 and subsequent tax years. If the corporation's net alternative minimum tax in subsequent tax years results in getting an additional credit, that credit is added to any carryforward balance from earlier years.

General business credit. The general business credit allowable for a tax year in which the regular tax exceeds the tentative minimum tax is determined as if:

- The portion of the general business credit (not attributable to the regular investment credit) first offset the regular tax, and
- The regular investment credit (if otherwise available) reduced the net tax to 75% of the tentative minimum tax.

However, the regular investment tax credit cannot be used in a tax year if the corporation's income tax (net of all nonrefundable credits) will be less than 10% of the tentative minimum tax (figured without the alternative tax net operating loss deduction and the foreign tax credit).

Estimated Income Tax

Every corporation whose tax is expected to be $500 or more is required to make estimated tax payments. A corporation's estimated tax is the amount of its expected tax liability (including alternative minimum tax and environmental tax) less its allowable tax credits.

Time and amount of deposits. If a corporation's estimated tax is $500 or more, its estimated tax payments must be deposited with an authorized financial institution or a Federal Reserve Bank. Each deposit must be accompanied by a federal tax deposit coupon and deposited according to the instructions in the coupon book.

The due date of deposits and the amount of installments to be deposited are determined according to the table below (but, see *Saturday, Sunday, or holiday*, discussed later, under *Due Date of Return*).

The following table indicates the part of a corporation's estimated tax that should be deposited on or before the 15th day of the following months of the corporation's tax year.

Required Installment	Month Due
1st	4th month
2nd	6th month
3rd	9th month
4th	12th month

Example 1. The Penn Corporation is a calendar year taxpayer that first meets the requirements for making estimated tax deposits on March 24 and estimates that its tax will be $40,000. The corporation should pay the estimated tax in four $10,000 installments: on April 15, June 15, September 15, and December 15.

Example 2. The Jones Company has a fiscal year beginning April 1 and ending March 31. It first meets the requirement for making estimated tax deposits on July 1 and estimates its tax to be $12,000. The estimated tax should be paid in the following four $3,000 installments: on July 15, September 15, December 15, and March 15.

Amended estimated tax. If, after figuring and making payments of estimated tax, a corporation determines that its estimated tax is substantially larger or smaller than originally estimated, it should refigure the tax before the next installment to determine the amount of its remaining installment payments.

Example. A calendar year corporation determined that its estimated tax is $20,000. The corporation pays the first two installments on April 15 and June 15 in the amount of $5,000 each (25% of $20,000). On July 1, the corporation discovers that its estimated tax can reasonably be expected to be $40,000. The installments payable on September 15 and December 15 will be $15,000 each, figured as follows:

Refigured estimated tax	$40,000
Less: Prior estimated tax payments made	10,000
Unpaid balance	$30,000
Installments payable on September 15 and December 15 (unpaid balance ($30,000) divided by remaining installments (2))	$15,000

Penalty

A corporation that fails to pay in full a correct installment of estimated tax by the due date is generally subject to a penalty. The penalty rate is applied to the period of underpayment for any installment. The penalty is figured at a rate of interest published quarterly by the IRS.

Figuring the underpayment. The underpayment of any installment is the amount required to be paid minus the amount paid by the due date of the installment.

The ***amount required to be paid*** is an installment based on the lesser of:

1) 90% of the tax shown on the return for the tax year (or if no return is filed, 90% of the tax for the year), or
2) 100% of the tax on the return for the preceding year, if that year was a 12–month tax year and a return for that year was filed showing a tax liability.

Large corporation. A ***large corporation*** (one that has at least $1 million of taxable income in any of the last 3 years) may use (1) or (2), if applicable, only for determining the amount of its first installment in any tax year. The difference, if any, between the installment determined under (1) and that determined under (2), must be added to the next required installment.

Order of crediting payments. An estimated tax payment is credited against unpaid installments in the order in which they are required to be paid.

Annualizing. If an installment is based on 90% of the current year's tax that would be due if income were annualized (what the total income for the tax year would have been if an amount of income actually received over a specific period within the tax year were received at the same rate over the full 12–month year), ***no penalty*** is imposed. Any reduction in a required installment from using the annualization exception must be added to the amount of the next required installments if not taken in account in earlier installments.

Recurring seasonal income. When figuring the penalty for an underdeposit of an installment of estimated tax, there is a special rule for a corporation with recurring seasonal income. The rule applies to corporations whose taxable income for any period of 6 consecutive months has averaged 70% or more of its taxable income for the year during each of the past 3 tax years.

No penalty for underdeposit of an installment of estimated tax will apply if the total of all payments of estimated tax paid on or before the installment date equals or exceeds 90% of the amount, figured as follows:

1) Take the taxable income for all months in the tax year that precede the filing month—that is, the month in which the installment is required to be paid.
2) Divide the amount in (1) by the base period percentage, defined below, for all months in the tax year preceding the filing month.
3) Figure the tax on the amount figured in (2).
4) Multiply the tax figured in (3) by the base period percentage for the filing month and all months during the tax year before the filing month.

The ***base period percentage*** for any period of months is the average percentage that the taxable income for the corresponding months in each of the 3 preceding tax years bears to the taxable income for the 3 preceding tax years.

Form 1120–W (WORKSHEET), Corporation Estimated Tax. As an aid in determining its estimated tax and required installments, a corporation should obtain a copy of Form 1120–W (WORKSHEET). This form should be retained and not filed with the IRS.

Form 2220, *Underpayment of Estimated Tax by Corporations.* This form is used to compute the penalty for underpayment of estimated tax. If it appears from your Form 1120 or Form 1120–A that you have underpaid your estimated tax, but you feel that you qualify for relief from the penalty under any of the above exceptions, attach a statement to your return explaining why you believe the penalty does not apply. For this purpose, you may use Form 2220.

Quick Refund of Overpayments

A corporation that overpays its estimated income tax may apply on Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax,* for an adjustment or quick refund of any overpayment. This application must be made after the close of the corporation's tax year and on or before the 15th day of the 3rd month thereafter, and before the corporation files a return for that tax year.

The overpayment must be at least 10% of the amount estimated by the corporation on its application as its income tax liability for the tax year and amount to at least $500. The IRS will credit or refund the overpayment within 45 days after the application is filed.

Filing Requirements

Each corporation, unless specifically exempt, must file a tax return even if it had no taxable income for the year and regardless of the amount of its gross income for the year. The income tax return for ordinary corporations is Form 1120, *U.S. Corporation Income Tax Return.* Form 1120–A, *U.S. Corporation Short-Form Income Tax Return,* may be filed by certain small corporations. Corporations that normally file Form 1120 will probably save time if they are able to use Form 1120–A.

A corporation must file an income tax return unless it has dissolved, even if it has stopped doing business and disposed of all its assets except for a small sum of cash retained to pay state taxes to preserve its corporate charter. A corporation may also be required to file a return for any year following the year in which it dissolved if it carries on substantial activities, such as the collection of assets or the payment of obligations, in connection with the termination of its business affairs.

A corporation that has no assets need not file an income tax return after it stops doing business and dissolves. This is so even if it is treated as a corporation under state law for certain limited purposes connected with winding up its affairs, such as suing or being sued. A receiver or trustee in bankruptcy ordinarily must file tax returns for a corporation in bankruptcy. However, the receiver or trustee may be relieved of this responsibility if dissolution has occurred in fact (that is, the corporation has ceased business and has neither assets nor income.)

Who Can File Form 1120–A

Form 1120–A can generally be used by a corporation to report its taxable income if it meets the following requirements:

- Its gross receipts must be under $500,000,
- Its total income must be under $500,000,
- Its total assets must be under $500,000,
- It does not have ownership in a foreign corporation,
- It does not have foreign shareholders who own, directly or indirectly, 50% or more of its stock,
- It is not a member of a controlled group or a personal holding company,
- It is not a consolidated corporate return filer,
- It is not a corporation undergoing a dissolution or liquidation,
- It is not filing its final tax return,
- It has no nonrefundable tax credits other than the general business credit and the credit for prior-year minimum tax,
- Its only dividend income is from domestic corporations and those dividends that qualify for the 80% (or 70%) deduction,
- It is not an organization such as an S corporation, life or mutual insurance company, political organization, etc., that is required to file a specialized form such as Form 1120S, 1120–L, 1120–POL, etc.,
- It has no liability for interest relating to certain installment sales of timeshares and residential lots, or interest on deferred tax liability or installment payments of tax, and
- It is not subject to environmental tax.

For more information, see *Instructions for Forms 1120 and 1120–A.*

Amending Return

If, after filing Form 1120 or Form 1120–A, you have to correct an error on the return, such as understated or overstated income, or failure to claim deductions or credits, you must do so by filing Form 1120X, *Amended U.S. Corporation Income Tax Return.*

Where to File

A corporation files its income tax return with the Internal Revenue Service Center serving the area where the principal office for keeping the corporation's books and records is located. Service Center locations are listed in the instructions to the forms.

The separate income tax returns of a group of corporations located in several Service Center regions may be filed with the Service Center for the area in which the principal office of the managing corporation (that keeps all the books and records) is located.

Due Date of Return

If a corporation's income tax return is made on a calendar year basis, the return must be filed on or before March 15 following the close of the tax year. If a corporation uses a fiscal year as its tax year, its return must be filed on or before the 15th day of the 3rd month following the close of its fiscal year.

Saturday, Sunday, or holiday. If the last day (due date) for performing any act for tax purposes, such as filing a return or making a tax payment, falls on a Saturday, Sunday, or legal holiday, you may perform the act on the next day that is not a Saturday, Sunday, or legal holiday.

Extension of time for filing. A corporation will receive an automatic 6–month extension of time for filing a return by submitting an application for extension on Form 7004, *Application for Automatic Extension of Time To File Corporation Income Tax Return.* This form is filed with the Internal Revenue Service Center where the corporation will file its income tax return. The IRS may terminate this extension at any time by mailing a notice of termination to the corporation. Form 7004 must be filed by the due date of the corporation's income tax return.

Any automatic extension of time for filing a corporation income tax return will not extend the time for paying the tax due shown on the return.

Automatic extensions of time to file corporate income tax returns will be allowed without payment so long as Form 7004 is accompanied by Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback,* showing an expected net operating loss carryback that will eliminate the tentative tax shown on Form 7004.

Interest. Interest is charged on the difference in the amount between the tentative tax reported on Form 7004 and the actual tax the corporation must pay when it files its income tax return.

Payment of Tax

The balance of any income tax due, after installments were paid on estimated tax, must be paid by the due date of the return.

Income tax payment must be made either to an authorized financial institution or to a Federal Reserve Bank. All deposits must be made with a federal tax deposit coupon in accordance with the instructions in the coupon book.

Penalties

There are several penalties that can be imposed against a corporation. Some of these are discussed next.

Failure to file. If a corporation's income tax return is not filed by the due date (including extensions), and if it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for 1 month or less. An additional 5% is imposed for each additional month or part of a month the delinquency continues, not exceeding a total of 25%. The tax due is the tax liability that would be shown on a return, less credits and any tax payments made before the due date. The delinquency penalty will be reduced by an amount equal to that imposed under the failure-to-pay tax penalty.

If the return is not filed within 60 days of the due date (including extensions), the penalty for failure to file, unless reasonable cause is shown, will be at least $100 or the balance of tax due, whichever is less.

Reasonable cause. A corporation that wishes to avoid a penalty for failure to file a tax return or pay the tax must be able to show reasonable cause. This should be done by filing, with the Director of the Service Center where the return must be filed, a statement of the facts establishing reasonable cause for the corporation's failure to file a return or pay the tax on time. In addition, the statement must contain a declaration that it was made under the penalties of perjury.

Failure to pay tax. Payments made after the due date are subject to an interest charge, even if filing extensions were granted. Payments of income tax other than estimated tax made after the due date may also be subject to a penalty of .5% a month or part of a month up to a maximum of 25%. In certain cases, the penalty for failure to pay taxes by the due date increases from .5% to 1% per month or part of a month up to a maximum of 25% of the tax.

Other penalties. There are other civil penalties that can also be imposed for negligence, substantial understatement of tax, and fraud. Criminal penalties may be imposed for willful failure to file, tax evasion, or making a false statement.

Capital Contributions and Retained Earnings

Contributions made by stockholders to a corporation and contributions made by others to a corporation are treated differently by the corporation.

Paid-in capital. The total contributions made by stockholders to a corporation, whether in exchange for stock or otherwise, are ***paid-in capital***. These contributions are not taxable income to the corporation.

However, contributions to a corporation in aid of construction or any other contribution as a customer or potential customer is taxable income to the corporation.

Contributions by others. If a corporation acquires property as a gift from a city or town, there is a contribution to capital. The basis of this property is zero.

Reduction of basis. If a corporation receives, from a person other than a stockholder, a cash contribution for use in acquiring certain property, and the amount contributed is more than the cost of the property acquired, then the basis of the other properties held by the corporation on the last day of the 12–month period beginning on the day the contribution was received must be reduced, but not below zero, in the following order:

1) Depreciable property,
2) Amortizable property,
3) Property subject to cost depletion but not to percentage depletion, and
4) All other remaining properties.

The basis of property in a category ((1), (2), (3), or (4), above) must be reduced to zero before going to the next category. There may be more than one piece of property in each category.

In the last category to be adjusted, the reduction of the basis of each of the properties must be made based on the ratio of the basis of each piece of property to the total basis of all property in that category. If the corporation wishes to make this adjustment in the last category in some other way, it must get the consent of the IRS. The corporation should file a request for consent with its income tax return for the tax year in which the transfer of property occurs.

Accumulation of retained earnings. A corporation is permitted to accumulate its earnings for use in a possible expansion or for other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of 28%. If the accumulated earnings tax applies, interest will be charged on underpayments of tax from the date the corporate return was originally due, without regard to extensions. This tax applies without regard to the number of shareholders in the corporation.

An accumulation of $250,000 or less is considered within the reasonable needs of a business (except those whose principal function is performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, who have a $150,000 limit). In determining if the corporation has accumulated earnings and profits beyond its reasonable needs, the listed and readily marketable securities owned by the corporation and purchased with its earnings and profits must be valued at net liquidation value, not at cost. The reasonable needs of the business include:

- Specific, definite, and feasible plans for use of the earnings accumulation in the business; and
- The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, provided the value of the shares does not exceed the reasonably anticipated total estate and inheritance taxes, and funeral and administration expenses incurred by the shareholder's estate.

If a corporation with accumulated earnings of more than $250,000 does not make regular distributions to its shareholders, it should be prepared to show a bona fide business reason for not doing so.

For a corporation to avoid liability for accumulated earnings tax, if it accumulates earnings and profits beyond its reasonable business needs, it must show that tax avoidance with respect to shareholders is not one of the purposes of accumulation. The simple existence of a tax avoidance purpose is sufficient for imposing the accumulated earnings tax.

Reconciliation Statements

When Form 1120 is filed, Schedules M–1 and M–2 must be completed if the corporation's total assets are at least $25,000. If Form 1120–A is filed, Part III of that form must be completed.

Schedule M–1. Schedule M–1 starts with the net income per books, after allowance of federal income tax accrued for the year for which the return is being filed, as shown in the corporation's profit and loss account. Schedule M–1 provides for necessary adjustments to reconcile this amount with the taxable income shown on Form 1120 line 28, page 1.

Part III. Part III, Form 1120–A, is similar to Schedule M–1, Form 1120, and must be completed. The income per books is reconciled with the taxable income shown on Form 1120–A line 24, page 1. The less-than-$25,000 asset exception does not apply to Form 1120–A filers.

Schedule M–2. Schedule M–2 analyzes the retained earnings as shown in Schedule L, the corporation's balance sheet.

To complete these schedules properly, first derive additional information from your corporation's books and records.

Example. The following profit and loss account appeared in the books of the Welldon Corporation for the calendar year 1990. Welldon Corporation files Form 1120 and completes Schedules M–1 and M–2, as illustrated later.

Account		Debit	Credit
Gross sales			$1,840,000
Sales returns and allowances		$ 20,000	
Cost of goods sold		1,520,000	
Interest income:			
From banks	$10,000		
On tax-exempt state bonds	5,000		15,000

Proceeds from life insurance (death of corporate officer)		6,000
Bad debt recoveries (no deduction previously made for tax purposes)		3,500
Insurance premiums on life of corporate officers (corporation is beneficiary of policies)	9,500	
Compensation of officers	40,000	
Salaries and wages	28,000	
Repairs	800	
Taxes	10,000	
Contributions:		
Deductible $23,000		
Nondeductible 500	23,500	
Interest paid (on loan to purchase tax-exempt bonds)	850	
Depreciation	5,200	
Loss on securities	3,600	
Net income per books after federal income tax	130,150	
Federal income tax accrued for 1990	72,900	
Total	$1,864,500	$1,864,500

Retained earnings were analyzed and the following appeared in this account in the corporation's books:

Item	Debit	Credit
Balance, January 1, 1990		$225,000
Net profit (before federal income tax)		203,050
Reserve for contingencies	$ 10,000	
Income tax accrued for 1990	72,900	
Dividends paid during 1990	129,414	
Refund of 1987 income tax		18,000
Balance, December 31, 1990	233,736	
Total	$446,050	$446,050

The following was entered on Form 1120, page 1:

Gross sales ($1,840,000 less returns and allowances of $20,000)		$1,820,000
Cost of goods sold		1,520,000
Gross profit from sales		$ 300,000
Interest income		10,000
Total income		$ 310,000
Deductions		
Compensation of officers	$40,000	
Salaries and wages	28,000	
Repairs	800	
Taxes	10,000	
Contributions (maximum allowable)	22,500	
Depreciation	6,200	
Total deductions		107,500
Taxable income		$ 202,500

Schedule M–1

Line 1. Line 1 is the net income per books, $130,150, shown in the profit and loss account previously as net income per books after federal income tax.

Line 2. Line 2 is the federal income tax accrued for the year for which the return is made, $72,900.

Line 3. Line 3 is for capital losses that exceed capital gains. The net loss on securities, $3,600, is entered on this line.

Line 4. Line 4 should show all income and credits included in taxable income that are not recorded in the corporation's books. This can occur if assets are valued in the corporation's books at an amount greater than that used for tax purposes. When a sale of such assets is made, the gain included in taxable income is greater than that recorded in the books, and the difference is shown here.

Line 5. Line 5 is for expenses recorded on the corporation's books that may not be deducted on this return. Besides the $500 listed on line 5b as contributions that were over the 10% limit, the remaining nondeductible expenses are shown on an itemized statement attached to the return and include the following:

Insurance premiums paid on a policy covering the life of an officer or employee in which the corporation is directly or indirectly a beneficiary	$ 9,500
Nondeductible interest incurred to purchase or carry tax-exempt interest obligation	850
Nondeductible contributions	500
Total	$10,850

Line 6. Line 6 is the total of lines 1 through 5.

Line 7. Line 7 shows income recorded on the corporation's books during the year that is not included on the return. This totals $14,500 and includes interest on tax-exempt state bonds of $5,000, nontaxable insurance proceeds of $6,000, and a nontaxable bad debt recovery of $3,500.

Line 8. Line 8 should include the total of all deductions claimed for tax purposes that are not charged against book income. The corporation enters $1,000 on line 8a. It represents the difference between the amount of depreciation claimed on the corporation's income tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there was not enough space on the line, it would have to attach a statement to the return listing them.

Line 9. Line 9 shows the total of lines 7 and 8, or $15,500.

Line 10. Line 10 shows $202,500, the difference between lines 6 and 9. The amount on line 10 must agree with the taxable income before the net operating loss deduction and special deductions shown on line 28, page 1, Form 1120.

Schedule M–2

Line 1. Line 1 shows $225,000, which is the figure taken from Schedule L for the beginning of the tax year for which the return is made.

Line 2. Line 2 is $130,150, the net income per books (after federal income tax).

Line 3. Line 3 must show all other increases to retained earnings. The refund of 1987 income tax, $18,000, is entered on this line.

Schedule M-1 Reconciliation of Income per Books With Income per Return (This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books	130,150	7 Income recorded on books this year not included on this return (itemize):	
2 Federal income tax	72,900	a Tax-exempt interest $ 5,000	
3 Excess of capital losses over capital gains	3,600	b Insurance Proceeds $6,000	
4 Income subject to tax not recorded on books this year (itemize):		c Bad Debt Recovery $3,500	14,500
5 Expenses recorded on books this year not deducted on this return (itemize):		8 Deductions on this return not charged against book income this year (itemize):	
a Depreciation $		a Depreciation $ 1,000	
b Contributions carryover $ 500		b Contributions carryover $	
c Travel and entertainment $ See Itemized Statement Attached $ 10,850	11,350		1,000
		9 Total of lines 7 and 8	15,500
6 Total of lines 1 through 5	218,000	10 Income (line 28, page 1)—line 6 less line 9	202,500

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (line 25, Schedule L) (This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Balance at beginning of year	225,000	5 Distributions: a Cash	129,414
2 Net income per books	130,150	b Stock	
3 Other increases (itemize): Refund of 1987 Income Tax	18,000	c Property	
		6 Other decreases (itemize): Reserve for Contingencies	10,000
		7 Total of lines 5 and 6	139,414
4 Total of lines 1, 2, and 3	373,150	8 Balance at end of year (line 4 less line 7)	233,736

Line 4. Line 4 shows $373,150, the total of lines 1, 2, and 3.

Line 5. Line 5 must include all distributions to stockholders charged to retained earnings during the tax year. The distributions, $129,414, are shown on this line.

Line 6. Line 6 is for any decreases (other than those on line 5) in unappropriated retained earnings. These decreases are not deductible on the tax return at the time of the appropriation. However, a deduction may be permissible at a later date. A common example of this is an amount set aside for contingencies. A customer was injured on company property during 1990 and the company retained an attorney. A contingent liability of $10,000 was set up for the customer's claim. If this claim is settled during 1991 for $5,000 and the attorney's fee is $2,500, the retained earnings (appropriated) would be charged $7,500. The $7,500 would be deducted in arriving at taxable income for 1991. Another common example of items entered on this line is the

WELLDON CORPORATION
CURRENT-YEAR COMPUTATION OF EARNINGS AND PROFITS
CALENDAR TAX YEAR 1990

Incorporated 1/1/46 Accrual Accounting Basis				SCHEDULE M PER RETURN DR (Debit)	 CR (Credit)	EARNINGS AND PROFITS CURRENT-YEAR ACCUMULATED DR (Debit)	 CR (Credit)	 CR BAL	 KEY
12/31/89 Balance forward					$225,000 (A)			$1,200	
1990									
Taxable income (line 28, p. 1) per return					$202,500 (B)		$202,500		*
Federal income taxes—per books				$72,900 (C)					a
—per tax returns						$72,900			a
Excess of capital losses over capital gains (Tax Basis)		3,600	(D)			3,600			*
Contributions in excess of 10% limit		$500	(E)			500			*
Life ins. prem. in excess of cash surrender value (CSV)		9,500	(F)			9,500			*
Nondeductible interest paid for tax-exempt state bonds		850	(G)			850			*
Nondeductible contributions		500	(H)			500			*
Total itemized per line 5, Schedule M-1				11,350 (I)					
Tax-exempt interest received on tax-exempt state bonds		$ 5,000	(J)				5,000		*
Life ins. proceeds in excess of cash surrender value		6,000	(K)				6,000		*
Bad debt recovery (not charged against taxable income)		3,500	(L)						x
Total itemized per line 7, Schedule M-1					14,500 (M)				
Depreciation on return in excess of straight line					1,000 (N)		1,000		*
Refund of 1987 federal income taxes					18,000 (O)				1–87
Reserve for contingencies				10,000 (P)					x
						$ 87,850	$214,500		
Current-year earnings and profits							$126,650		
Cash distributions:									
Preferred:									
3/15, 6/15, 9/14, 12/14/90									
$7.4414/SH—10,000 share distribution		$74,414	(Q)			$ 74,414			*
Common:									
3/15/90									
$1.10/SH—25,000 shares									
	%								
From current-year earnings and profits	94.97	$26,118	(R)			26,118			*
From acc. earnings and profits	4.36	1,200	(S)					($1,200)	*
From capital	0.67	182	(T)						x
Total distributions	100%	$27,500							
9/15/90									
$1.10/SH—25,000 shares									
From current-year earnings and profits	94.97	26,118	(U)			26,118			*
From capital	5.03	1,382	(V)						x
Total distributions	100%	$27,500							
Total cash distributions				129,414 (W)					
				$227,264	$236,000	$126,650	$126,650		
Current-year change					8,736 (X)			($1,200)	
Balance forward 12/31/90					$233,736 (Y)			-0-	

KEY SYSTEM

* Identical items on the same list in Schedule M and Earnings and Profits.
(Alphabet) Items completely offset in same year. Start with (a) each year.
(Dates) Items which as of the final balance sheet's date have been completely offset in various years. Use consecutive dates to show the years for the purpose of locating offsets.
(x) Items which have not been completely offset and are differences between Schedule M and Earnings and Profits.

payment of the prior years' federal tax. A schedule must be attached to the return listing all items taken into account to arrive at the amount shown on this line.

Line 7. Line 7 shows $139,414, the total of lines 5 and 6.

Line 8. Line 8 shows the retained earnings of the corporation at the end of the tax year for which the return is made. This figure is determined by subtracting the total on line 7 from the total on line 4. This figure must agree with the amount shown in Schedule L for the end of the year for which the return is made. As shown in the schedule, $233,736 is entered in Schedule L.

Earnings and Profits Computations

In determining the taxable status of corporate distributions to stockholders, it is necessary to know the corporation's earnings and profits. See *Taxable Status of Distribution*, later.

Taxable distributions are made first from current earnings and profits and then from accumulated earnings and profits. Accumulated earnings and profits means earnings and profits accumulated since February 28, 1913. To the extent the distributions exceed both the current and the accumulated earnings and profits, the distributions may be partly or completely nontaxable.

If the distributions are either partly or completely nontaxable because they exceed current and accumulated earnings and profits, the corporation will need to file Form 5452, *Corporate Report of Nondividend Distributions*. See *Taxable Status of Distribution*, later, for more information about Form 5452. With Form 5452, you will need to attach computations of current year earnings and profits and accumulated earnings and profits along with schedules reconciling earnings and profits with taxable income and retained earnings. One format for showing the computation of current year earnings and profits is shown above.

Example. In addition to the facts set out earlier, the Welldon Corporation was incorporated on January 1, 1946, and utilizes an accrual method of accounting. Its accumulated earnings and profits as of December 31, 1989, were $1,200. The distributions made by Welldon Corporation during its calendar tax year 1990 in the amount of $129,414 consisted of $74,414 cash paid to holders of preferred stock and $55,000 cash paid to holders of common stock. The entire cash distribution paid to preferred stockholders is a taxable dividend. The $27,500 cash distribution paid on March 15, 1990, to common stockholders is a taxable dividend to the extent of $27,318 (99.33%), and the $27,500 cash distribution paid on September 15, 1990, to common stockholders is a taxable dividend to the extent of $26,118 (94.97%). The balance of retained earnings in Schedule M–2 as of December 31, 1990, is $233,736, but earnings and profits has a zero balance.

Explanation of Items for the Example

A) Amounts of retained earnings will generally differ from amounts of accumulated earnings and profits because of differences in computing book earnings and tax earnings. See item (X), below.

B) Taxable income (before special deductions) is used as a starting point for figuring current-year earnings and profits.

C) Taxes accrued for book income may differ from the amount of the actual federal income tax liability. In this case, only the latter amount is reflected in earnings and profits.

D) Capital losses are allowed in the year incurred, but must be added back in the tax year they are applied, against later gains, to prevent a double deduction.

E) Excess contributions, like excess capital losses, are allowable in the year the gift is made and must be added back in the year they are deducted.

F) Since only the premium in excess of the increase of cash surrender value represents an expense to the corporation, only such amount reduces earnings and profits.

G) Nondeductible interest expenses are expenses of the corporation and hence reduce earnings and profits.

H) Nondeductible contributions—same treatment as item (G).

I) Sum of items (E) through (H).

J) Tax-exempt interest income is added to earnings and profits because it is income to the corporation.

K) Insurance proceeds (in excess of cash surrender value)—same treatment as item (J).

L) Recovery represents a difference between the corporation's book and the tax basis of its reserve for bad debts.

M) Sum of items (J), (K), and (L).

N) Depreciation claimed on the return that is in excess of straight line increases the corporation's current earnings and profits.

Note: For tangible property, depreciated under the modified accelerated cost recovery system (MACRS), the adjustment to earnings and profits for depreciation is the amount figured using the alternate MACRS method. If you elect to expense the cost of property under section 179, the amount deductible under section 179 in figuring earnings and profits is deducted ratably over a 5-year period that begins in the year the cost is expensed. See Publication 534, *Depreciation*, for more information on MACRS and the section 179 deduction.

O) The refund represents a reduction of the corporation's 1987 income tax and therefore affects the earnings and profits of a prior year.

P) This amount represents a difference between the corporation's book and the tax basis of its reserve for contingencies and will not affect earnings and profits until it is allowed as a deduction in computing taxable income.

Q) Preferred shareholders, in this case, have a right to current-year earnings and profits before common shareholders.

R) Allocable share of remaining current-year earnings and profits.

S) Accumulated earnings and profits are reduced by distributions in excess of current-year earnings and profits.

T) Capital of a corporation is reduced by distributions paid in excess of earnings and profits that represent nontaxable dividends to shareholders.

U) Same as item (R).

V) Same as item (T).

W) Sum of items (Q) through (V).

X) Represents the sum of the current year differences (keyed as x) between figuring the corporation's book earnings and its tax earnings. These items plus items (O) and (S) account for the total current-year change of $8,736.

Y) Represents the accumulated differences between the corporation's book earnings and its accumulated tax earnings.

For more information, see Revenue Procedure 75–17, 1975–1 C.B. 677. A copy of this revenue procedure can be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Distributions

This section contains a discussion of distributions to stockholders by a corporation. Such distributions may be taxed as ordinary dividends, may be stock dividends, or may be treated as a return of capital. Distributions in property, as well as distributions in money, are discussed. This discussion generally applies only to regular domestic corporations.

In general, any distribution made out of earnings and profits by a corporation to its stockholders is considered a ***dividend.*** However, a distribution is not a taxable dividend if it is a return of capital to the stockholder. Most distributions are in money, but they may also be made in stock or other property. For information on the reporting of dividends and other distributions by stockholders, see Publication 550, *Investment Income and Expenses*.

A Form 1099–DIV, *Statement for Recipients of Dividends and Distributions*, must be filed with the IRS for each stockholder to whom a corporation pays gross dividends of $10 or more during a calendar year. The corporation is required to file Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, to summarize and transmit its Forms 1099–DIV. Form 5452 must be filed if nontaxable dividends are paid. Forms 1099–DIV and transmittal Form 1096 should be filed after September 30 of the year of payment (but not before the final payment for the year) and on or before February 28 of the year following the close of the calendar year during which the payments were made.

Forms 1099–DIV or substitute Forms 1099–DIV that meet certain requirements may be ***furnished to the stockholders*** after November 30 of the year of payment (but not before the final payment for the year). However, this statement may be furnished to the stockholders at any time after April 30 of the year of payment if it is furnished with the final dividend for that calendar year. This information must be furnished on or before January 31 of the year following the close of the calendar year during which the payments were made.

Withholding on dividends. Backup withholding may require a corporation to withhold tax equal to 20% of the dividends paid to certain shareholders. A Form 1099–DIV must be filed if there is backup withholding, regardless of the amount of the dividend. See Publication 505, *Tax Withholding and Estimated Tax*, for more information on backup withholding.

Amount of Distribution

The amount of a distribution received by a shareholder (corporate or noncorporate) is any money received plus the fair market value (on the distribution date) of other property received.

Property. Property means any property including money, securities, and indebtedness to the corporation, except stock of the distributing corporation or rights to acquire such stock.

Gain to be recognized by distributing corporation. Generally, the distributing corporation does not recognize gain on a distribution (not in complete liquidation) of property to its stockholders. However, if appreciated property is distributed to shareholders, gain is required to be recognized by the distributing corporation as if it sold the property for its fair market value.

When a corporation distributes property in satisfaction of its declared dollar dividend amount, it has made a taxable exchange. The declared dollar amount of the dividend is the amount received by the corporation in exchange for its property. But, if the corporation declares a dividend in property, the distribution of property is generally not an exchange on which the corporation realizes income. However, see *Distributions of Appreciated Property*.

Transfers of property to shareholders for less than fair market value. A sale or exchange of property between a corporation and a shareholder may be a dividend to the shareholder.

If the fair market value of the property at the date of distribution exceeds the price paid by the shareholder, the excess is a property distribution. This determination will be made without regard to whether the shareholder is a corporate or noncorporate shareholder.

Corporation canceling debt owed by shareholder. If a corporation cancels a shareholder's debt without repayment by the shareholder, the amount cancelled is treated as a distribution to the shareholder.

Distributions of Appreciated Property

If a corporation distributes property, other than its own obligations, to a shareholder and the fair market value of the property exceeds the corporation's adjusted basis in the property, the property is treated as being sold at the time of the distribution. The corporation will recognize gain on the excess of the fair market value over the adjusted basis of the property.

Note: Under Notice 89-37, 1989-1 C.B. 679, a partnership's acquisition, or ownership, or distribution of stock in one of its corporate partners (or the stock of any member of the partner's affiliated group) may constitute or have the effect of a redemption of such stock with property. Consistent with the purposes of the repeal of the *General Utilities Doctrine*, to the extent the property is appreciated, gain (not loss) will be recognized.

This rule is effective for all such transactions occurring after March 9, 1989. However, transactions that occurred prior to this date may be subject to tax under the substance-over-form principle or the disguised sale rule of section 707(a)(2)(B) of the Code. The IRS is in the process of developing regulations that will address such transactions in detail.

Distributions of Depreciable Property

If the fair market value of depreciable **personal** or **real** property distributed by a corporation to its shareholders, either as a dividend or in liquidation, is more than the adjusted basis of that property, the corporation must report ordinary income because of depreciation even though the distribution might otherwise be nontaxable.

Basis of property to distributee shareholder. The basis of the property distributed to a shareholder will be its fair market value, without regard to whether the recipient shareholder is a corporate or noncorporate shareholder.

Taxable Status of Distribution

The part of a distribution from either current or accumulated earnings and profits is a dividend. The part of the distribution that is more than the earnings and profits must be used first to reduce the adjusted basis of the stock in the hands of the stockholder. Second, any amount that exceeds the adjusted basis of the stock held by the stockholder is treated as gain from the sale or exchange of property (usually a capital gain).

Whether a distribution is a taxable dividend to the stockholders, is applied against and used to reduce the adjusted basis of their stock, or is treated as gain from the sale of property depends upon whether the amount of the distribution is more than:

1) Earnings and profits for the tax year in which the distribution was made (figured as of the close of that year without reduction for any distribution made during the year), plus
2) Accumulated earnings and profits since February 28, 1913.

The amount of current earnings and profits at the time of the distribution does not necessarily determine whether the distribution is a taxable dividend.

If there is a deficit in earnings and profits for the tax year in which the distribution was made, the taxable status of the distribution depends upon the amount of accumulated earnings and profits. In determining accumulated earnings and profits, the deficit in earnings and profits for the current year is prorated to the dates of distribution.

Example 1. X, a calendar year corporation, had accumulated earnings and profits of $40,000 as of January 1, 1990, the beginning of its tax year. X had an operating loss of $50,000 for the first 6 months of 1990, but had earnings and profits of $5,000 for 1990. A distribution of $15,000 was made to the stockholders on July 2, 1990.

The entire distribution is an ordinary dividend, of which $5,000 is considered as being paid from 1990 earnings and profits and $10,000 is considered paid out of accumulated earnings and profits.

Example 2. Assume the same facts as in Example 1, except that the corporation had a deficit in earnings and profits (E & P) of $55,000 for 1990. To figure the available earnings and profits, the deficit is prorated to the date of the distribution as follows:

Accumulated E & P – 1/1/90	$ 40,000
E & P deficit for 1990 prorated to date of distribution – 7/1/90 (½ × $55,000)	(27,500)
E & P available – 7/1/90	$ 12,500
Distribution – 7/1/90 – taxable as a dividend	(12,500)
E & P deficit – 7/1 – 12/31/90	(27,500)
Accumulated E & P – 12/31/90	$ (27,500)

Nontaxable dividends. Nontaxable dividends are distributions made to shareholders with respect to their stock in the ordinary course of business, all or part of which are considered not taxable as dividends because the amount of the distributions is greater than the paying corporation's earnings and profits. Form 5452, *Corporate Report of Nondividend Distributions*, must be filed if nontaxable dividends are paid to stockholders. Tax-free stock dividends and distributions in exchange for stock in liquidations or redemptions are not considered nontaxable dividends.

Form 5452. Form 5452 must be filed with supporting data on or before February 28, 1991, with:

Assistant Chief Counsel
(Income Tax and Accounting)
P O Box 7604
Ben Franklin Station
Washington, DC 20044

Adjustment to Earnings and Profits

If a distribution is made in cash, the current earnings and profits should be decreased by that amount, but not below zero. If the distribution represents an obligation of the distributing corporation, the earnings and profits should be decreased by the principal amount of that obligation to that extent. If it is an original issue discount obligation, earnings and profits are reduced by the total issue price of the obligation to that extent. If the distribution is in other property, the earnings and profits should be decreased by the adjusted basis of that property or current earnings and profits, whichever is less.

Distribution of Stock and Stock Rights

A distribution to shareholders of stock or rights to acquire stock in your corporation is not included in the shareholder's gross income unless it is one of the following:

- A distribution in lieu of money,
- A disproportionate distribution,
- A distribution with respect to preferred stock,
- A distribution of convertible preferred stock, unless your corporation can establish to the satisfaction of the IRS that the distribution will not result in a disproportionate distribution, or
- A distribution of common and preferred stock resulting in the receipt of preferred stock by some common shareholders and receipt of common stock by other common shareholders.

Even if the distribution falls into one of these five categories, there must be sufficient earnings and profits for the distribution to be considered a dividend.

A ***distribution is in lieu of money*** if any shareholders are given an election to be paid either in stock (or rights to acquire stock) or in property.

If the common shareholders of a corporation receive a pro rata distribution of preferred stock and have an option to immediately redeem the preferred stock for money, the distribution is considered to be in lieu of money and is a distribution included in gross income.

A ***distribution of stock is disproportionate*** if some shareholders receive cash or other property and other shareholders receive increased proportionate interests in the assets or earnings and profits of the corporation. In determining whether there is a disproportionate distribution with respect to a shareholder, each class of stock is considered separately. Any security convertible into stock or any right to acquire stock is treated as outstanding stock.

Example. Your corporation has two classes of common stock outstanding. If it pays regular cash dividends on the one class and stock dividends on the other (whether in common stock or preferred stock), there is a disproportionate distribution and the stock dividends are considered distributions of property that may be ordinary dividends.

Certain transactions may be treated as distributions of stock if they increase a shareholder's proportionate interest in the earnings and profits or assets of the corporation. Such changes include a change in the conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption treated as a dividend distribution, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder.

Certain disproportionate distributions of stock on stock outstanding on ***January 10, 1969,*** made before 1991, may not be treated as a taxable dividend. For more information, see section 1.305-8 of the income tax regulations.

Expenses of issuing a stock dividend, including printing, postage, cost of advice sheets, fees paid to transfer agents, and fees for listing on stock exchanges, are not deductible business expenses. These costs must be capitalized.

Constructive Dividends—Insurance Premiums

If a corporation pays part or all of the premiums on insurance issued on the lives of certain shareholders and both the corporation and the shareholders derive benefits from it, part or all of the premiums paid by the corporation will be a constructive dividend. This is especially true in a closely held corporation.

Sample Returns

Form 1120–A (Short-Form)

Rose Flower Shop, Inc., is the corporation for which the sample return is filled out. Rose Flower Shop is engaged in the business of selling fresh cut flowers and plants. It uses an accrual method of accounting and files its returns on the calendar year.

A corporation may file Form 1120–A if it has gross receipts under $500,000, total income under $500,000, total assets under $500,000, and meets certain other requirements. Since Rose Flower Shop met all these requirements for 1990, it filed the simpler Form 1120–A.

Page 1

If possible when you prepare your return, you should use the pre-addressed label sent to you by the IRS. The pre-addressed label is designed to expedite processing and prevent errors. If you do not have a corporation tax form with a pre-addressed label, enter your corporation's name, street address, city, state, and ZIP code in the appropriate spaces on the first page. After entering the identifying information called for at the top of the page, Rose Flower Shop proceeds to report its items of income and deductions.

The name and employer identification number of the corporation should also be shown in the top margin of schedules and attachments to Form 1120–A.

All applicable items for income, deductions, and tax listed on page 1 of Form 1120–A should be filled in even though totals must be shown on the printed forms. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales for the year totaled $248,000, using the accrual basis of accounting. After subtracting $7,500 of returned goods and allowances, a net sales figure of $240,500 is entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $144,000, is computed by using the worksheet (not illustrated) provided in the form instructions.

Line 3. Net sales less cost of goods sold results in gross profit of $96,500.

Lines 4 through 10. Other items of income are shown next. During the year, the only other item of income for Rose Flower Shop was taxable interest of $942, shown on line 5.

Line 11. Total income amounts to $97,442.

Line 12. The salary of the company president totals $23,000 and is included on line 12.

Line 13. Other salaries and wages total $24,320 and are deducted on line 13a. This includes only salaries and wages not included on line 12 and not deducted as part of cost of goods sold on line 2. Rose Flower Shop was not entitled to a jobs credit, so $24,320 is also entered on line 13c.

Line 16. Rental expense for Rose Flower Shop's place of business was $6,000 for the year.

Line 17. Deductible taxes totaled $3,320.

Line 18. Interest expense accrued during the year amounted to $1,340. Interest to carry tax-exempt securities is not included. See Publication 535, *Business Expenses*, for a discussion of amounts deductible as interest, when the deduction may be taken, and nondeductible items.

Line 19. During 1990, Rose Flower Shop contributed $1,820 to various charitable organizations. The total of $1,820 is less than the limit for deductible contributions, which is 10% of taxable income figured without regard to the contribution deduction.

Line 22. Other deductions consist of $3,000 in advertising expense, entered on this line. If there had been several expenses included in the total, a supporting schedule would be required.

Line 23. Total deductions amount to $62,800.

Lines 24, 25, and 26. Taxable income, $34,642, is shown on line 24. Since Rose Flower Shop did not have a net operating loss or special deduction, $34,642 is also entered on line 26.

Tax summary. Enter on line 27 the total tax ($5,196) from Part I, line 7, page 2. Payments against the tax are listed on line 28. On the Rose Flower Shop return, the only payment is the four estimated tax payments totaling $6,000. It is entered on line 28b, line 28d, and as a total on line 28h. The resulting overpayment is $804, which Rose Flower Shop chooses to have credited to its 1991 estimated tax. Rose Flower Shop could have had the overpayment refunded if it wanted to.

Signature. Rose Flower Shop's return must be signed manually by the corporate officer authorized to sign it.

Page 2

Part I—Tax Computation. The tax computation schedule in the form instructions is used to figure the tax on line 1. Lines 3, 5, and 6, the other taxes and credits listed on Part I, do not apply to Rose Flower Shop. The tax of $5,196 is entered on lines 1, 4, and 7.

Additional Information. On page 2, all applicable questions must be answered. The business activity code number, business activity, and product or service information must be provided on lines (1), (2), and (3) of question G. Purchases of $134,014 appear on line (1)(a) of question J. Other costs of $9,466 appear on line (1)(c) of question J. The supporting itemization is not illustrated, but these costs consist basically of costs directly related to the sale of flowers, wreaths, and plants, such as flower pots, vases, stands, boxes, wire strands, and tissue paper.

Part II—Balance Sheets. Comparative balance sheets for the beginning and end of the tax year must be provided in Part II. Entries in Part II should agree with amounts shown elsewhere on the return or included on a worksheet. For example, the figures for beginning and ending inventories must be the same as those appearing on the worksheet in the form instructions for cost of goods sold.

Part III—Reconciliation of Income per Books With Income per Return. All Form 1120–A corporate filers must complete Part III. This is so even though Form 1120 corporate filers are not required to complete Schedule M–1, *Reconciliation of Income per Books With Income per Return*, if their total assets are less than $25,000.

To properly complete Part III, first get additional information from your corporation's books and records. The following profit and loss account appeared in the books of Rose Flower Shop for the calendar year 1990.

Account	Debit	Credit
Gross sales		$248,000
Sales returns and allowances	$ 7,500	
Cost of goods sold	144,000	
Interest income		942
Compensation of officers	23,000	
Salaries and wages	24,320	
Rents	6,000	
Taxes	3,320	
Interest expense	1,240	
Contributions	1,820	
Advertising	3,000	
Federal income tax accrued	5,196	
Net income per books after tax	29,446	
Total	$248,942	$248,942

Part III starts with the net income per books, after reduction for federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 24, page 1.

Line 1. This is the net income per books, $29,446, shown in the profit and loss account previously as net income per books after tax.

Line 2. This is the federal income tax accrued for the year of the return, $5,196.

Line 7. The taxable income, $34,642, is shown on line 24, page 1 (*Taxable income before net operating loss deduction and special deductions).*

Form **1120-A**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Short-Form Income Tax Return

Instructions are separate. See them to make sure you qualify to file Form 1120-A.

For calendar year 1990 or tax year beginning ..... , 1990, ending ..... , 19 .....

OMB No. 1545-0890

1990

A Check this box if corp. is a personal service corp. (as defined in Temp. Regs. sec. 1 441-4T—see instructions) ▶ ☐

Use IRS label. Otherwise, please print or type.

10-2134567 DEC90 D90 5995
ROSE FLOWER SHOP, INC.
38 SUPERIOR LANE
FAIR CITY, MD 20715

B Employer identification number

C Date incorporated 7-1-82

D Total assets (see Specific Instructions) $ 65,987

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Change in address

F Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶

Income

1a	Gross receipts or sales	248,000	b Less returns and allowances 7,500	c Balance ▶ 1c	240,500
2	Cost of goods sold (see Instructions)			2	144,000
3	Gross profit (line 1c less line 2)			3	96,500
4	Domestic corporation dividends subject to the 70% deduction			4	
5	Interest			5	942
6	Gross rents			6	
7	Gross royalties			7	
8	Capital gain net income (attach Schedule D (Form 1120))			8	
9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)			9	
10	Other income (see Instructions)			10	
11	**Total income**—Add lines 3 through 10		▶	11	97,442

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (see Instructions)			12	23,000
13a	Salaries and wages 24,320	b Less jobs credit	c Balance ▶	13c	24,320
14	Repairs			14	
15	Bad debts			15	
16	Rents			16	6,000
17	Taxes			17	3,320
18	Interest			18	1,340
19	Contributions (**see Instructions for 10% limitation**)			19	1,920
20	Depreciation (attach Form 4562)	20			
21	Less depreciation claimed elsewhere on return	21a		21b	
22	Other deductions (attach schedule) (Advertising)			22	3,000
23	**Total deductions**—Add lines 12 through 22		▶	23	62,800
24	Taxable income before net operating loss deduction and special deductions (line 11 less line 23)			24	34,642
25	**Less:** a Net operating loss deduction (see Instructions)	25a			
	b Special deductions (see Instructions)	25b		25c	

Tax and Payments

26	**Taxable income**—Line 24 less line 25c			26	34,642
27	**Total tax** (Part I, line 7)			27	5,196
28	**Payments:**				
a	1989 overpayment credited to 1990	28a			
b	1990 estimated tax payments	28b 6,000			
c	Less 1990 refund applied for on Form 4466	28c ( )	Bal ▶ 28d	6,000	
e	Tax deposited with Form 7004		28e		
f	Credit from regulated investment companies (attach Form 2439)		28f		
g	Credit for Federal tax on fuels (attach Form 4136). See Instructions		28g		
h	**Total payments**—Add lines 28d through 28g			28h	6,000
29	Enter any **penalty** for underpayment of estimated tax—Check ▶ ☐ if Form 2220 is attached			29	
30	**Tax due**—If the total of lines 27 and 29 is larger than line 28h, enter amount owed			30	
31	**Overpayment**—If line 28h is larger than the total of lines 27 and 29, enter amount overpaid			31	804
32	Enter amount of line 31 you want: **Credited to 1991 estimated tax** ▶ 804		**Refunded** ▶	32	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

George Rose — Signature of officer | 2-15-91 — Date | President — Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of the Instructions.

Form **1120-A** (1990)

Part I Tax Computation

1 Income tax (see Instructions to figure the tax). Check this box if the corp. is a qualified personal service corp. (see Instructions). ▶ ☐		1	5,196
2a General business credit. Check if from: ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586	2a		
b Credit for prior year minimum tax (attach Form 8801)	2b		
3 Total credits—Add lines 2a and 2b		3	
4 Line 1 less line 3		4	5,196
5 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611		5	
6 Alternative minimum tax (attach Form 4626). See Instructions		6	
7 Total tax—Add lines 4 through 6. Enter here and on line 27, page 1.		7	5,196

Additional Information (See General Instruction F.)

G Refer to the list in the Instructions and state the principal:

(1) Business activity code no. ▶ 5995

(2) Business activity ▶ Flower Shop

(3) Product or service ▶ Flowers

H Did any individual, partnership, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) Yes ☑ No ☐

If "Yes," attach schedule showing name, address, and identifying number. (Schedule not illustrated)

I Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ -0-

J (1) If an amount for cost of goods sold is entered on line 2, page 1, complete (a) through (c):

(a) Purchases (see Instructions)	134,014
(b) Additional sec. 263A costs (see Instructions —attach schedule)	
(c) Other costs (attach schedule)	9,466

(2) Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? Yes ☐ No ☑

K At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See General Instruction F for filing requirements for form TD F 90-22.1.) Yes ☐ No ☑

If "Yes," enter the name of the foreign country ▶

L Enter amount of cash distributions and the book value of property (other than cash) distributions made in this tax year ▶ $ -0-

Part II Balance Sheets

		(a) Beginning of tax year	(b) End of tax year
Assets	1 Cash	20,540	18,498
	2a Trade notes and accounts receivable		
	b Less allowance for bad debts	( )	( )
	3 Inventories	2,530	2,010
	4 U.S. government obligations	13,807	45,479
	5 Tax-exempt securities (see Instructions)		
	6 Other current assets (attach schedule)		
	7 Loans to stockholders		
	8 Mortgage and real estate loans		
	9a Depreciable, depletable, and intangible assets		
	b Less accumulated depreciation, depletion, and amortization	( )	( )
	10 Land (net of any amortization)		
	11 Other assets (attach schedule)		
	12 Total assets	36,877	65,987
Liabilities and Stockholders' Equity	13 Accounts payable	6,415	6,079
	14 Other current liabilities (attach schedule)		
	15 Loans from stockholders		
	16 Mortgages, notes, bonds payable		
	17 Other liabilities (attach schedule)		
	18 Capital stock (preferred and common stock)	20,000	20,000
	19 Paid-in or capital surplus		
	20 Retained earnings	10,462	39,908
	21 Less cost of treasury stock	( )	( )
	22 Total liabilities and stockholders' equity	36,877	65,987

Part III Reconciliation of Income per Books With Income per Return (Must be completed by all filers.)

1 Net income per books	29,446	6 Income recorded on books this year not included on this return (itemize)	
2 Federal income tax	5,196		
3 Excess of capital losses over capital gains		7 Deductions on this return not charged against book income this year (itemize)	
4 Income subject to tax not recorded on books this year (itemize)			
5 Expenses recorded on books this year not deducted on this return (itemize)		8 Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	34,642

Form 1120

Tentex Toys, Inc., is the corporation for which the sample return is filled out. Tentex is engaged in the business of manufacturing and selling children's toys and games. It uses an accrual method of accounting and files its returns on the calendar year.

Page 1

If possible, when you prepare your return you should use the pre-addressed label sent to you by the Internal Revenue Service. The pre-addressed label is designed to expedite processing and prevent errors. If you do not have a corporation tax form with a pre-addressed label, enter your corporation's name, the street address, and the city, state, and ZIP code in the appropriate spaces on the first page. After entering the identifying information called for at the top of the page, Tentex proceeds to report its items of income and deductions.

The name and employer identification number of the corporation should also be shown in the top margin of schedules and attachments to Form 1120.

All applicable items for income, deductions, tax, and payments listed on page 1 of Form 1120 should be filled-in even though totals must be shown on the printed forms. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales, line 1a, for the year totaled $2,010,000, using the accrual basis of accounting. After subtracting returned goods and allowances of $20,000, line 1b, a net sales figure of $1,990,000 is entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $1,520,000, is the total brought over from Schedule A (line 7) on page 2.

Line 3. Net sales less cost of goods sold results in gross profit of $470,000.

Lines 4 through 10. Other items of income are shown next. During the year, Tentex received $10,000 of dividends from domestic corporations, $5,000 of tax-exempt interest from state bonds, and $4,000 of taxable interest. It also received $500 interest on its business accounts receivable. The gross amount of dividends is entered on line 4 (note that the dividends-received deduction is taken on line 29b). Total taxable interest of $4,500 is shown on line 5. The tax-exempt interest is not included in income.

A section 481 adjustment of $1,000 is shown on line 10. This is due to the revalued beginning inventory (from a previous year) required by the uniform capitalization rules of section 263A costs (attached computation not illustrated). See Publication 538, *Accounting Periods and Methods*, for more information on the uniform capitalization rules.

Line 11. Total income amounts to $485,500.

Line 12. The salaries of the company president, vice president, and secretary-treasurer, listed on Schedule E, total $70,000 and are included on line 12. Schedule E is completed only if total receipts (line 1a plus lines 4 through 10 of page 1) are $500,000 or more.

Line 13. Other salaries and wages total $44,000 and are deducted on line 13a. This includes only salaries and wages not included on line 12 and not deducted as part of cost of goods sold on line 3, Schedule A on page 2. For a manufacturing company such as Tentex, this amount represents nonmanufacturing salaries and wages, such as office salaries. See Publication 535, *Business Expenses*, for a discussion of salaries and wages. Tentex is eligible for a $6,000 targeted jobs credit, which is figured on Form 5884 (not illustrated). The deduction for salaries and wages is reduced on line 13b by the allowable $6,000 credit. The balance, $38,000, is entered on line 13c.

Line 14. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. Repairs total $800. See Publication 535 for information on repairs, improvements, and replacements.

Line 15. Tentex uses the specific charge-off method of accounting for bad debts. Actual accounts written off during the year total $1,600. See Publication 535 for information on bad debt deductions.

Line 16. Rental expense for Tentex's office facilities was $9,200 for the year.

Line 17. Deductible taxes totaled $15,000.

Line 18. Interest expense accrued during the year amounted to $27,200. This included interest both on debts for business operations and debts to carry investments. Interest to carry tax-exempt securities is not included. See Publication 535 for a discussion of amounts deductible as interest.

Line 19. During 1990, Tentex contributed $11,400 to the United Community Fund and $12,600 to the State University scholarship fund. The total of $24,000 is more than the limit for deductible contributions, which is 10% of taxable income figured without regard to the contribution deduction and the special deduction entered on line 29b. The amount allowable under the limitation is $23,150, and this is entered on line 19. The excess of $850, not deductible this year, may be carried over as explained earlier in this publication. Also, during 1990, Tentex made contributions of $500 that are not deductible in any case.

Lines 20 and 21. Depreciation of $17,600 is brought forward from Form 4562 (not illustrated) and entered on line 20. This amount is reduced by the depreciation claimed on Schedule A ($12,400) and entered on line 21a. The balance ($5,200) is deducted on line 21b since it is the depreciation on the assets used in the indirect operations of the business.

Line 22. Depletion is entered on line 22. This item did not affect Tentex. See Publication 535.

Line 23. Advertising expense of $8,700 is entered on this line.

Lines 24 and 25. Profit-sharing, stock bonus, pension, and annuity plans are discussed in Publication 535. Tentex has no such plan.

Line 26. Other ordinary and necessary business deductions totaled $78,300. These included miscellaneous office expenses, sales commissions, legal fees, etc. A schedule itemizing these expenses must be attached to the return, even though it has not been shown in this example. Enter the total on line 26.

Line 27. Total deductions amount to $277,150.

Lines 28, 29, and 30. Taxable income, $208,350, is shown on line 28. Since Tentex did not have a net operating loss, its only entry on line 29 is the special dividends-received deduction of $8,000 brought forward from Schedule C, page 2. This is entered on lines 29b and 29c. Taxable income on line 30 is $200,350.

Tax summary. Enter on line 31 the total tax ($55,387) from Schedule J. Payments against the tax are listed on line 32. On the Tentex return, the only credit is the four estimated tax payments totaling $69,117. It is entered on lines 32b, 32d, and 32h. The resulting overpayment is $13,730, which Tentex chooses to have credited to its 1991 estimated tax. Tentex could have had the overpayment refunded if it had wanted to.

Signature. Tentex's return must be signed manually by the corporate officer authorized to sign it.

Page 2

Schedule A. Use Schedule A to report your cost of goods sold. Basically, this figure is beginning inventory, plus merchandise bought or produced during the year, less ending inventory. Because it is a manufacturer, Tentex must account for its costs of manufacturing as part of cost of goods sold. Goods on hand at the beginning of the year were valued at $126,000, using the lower of cost or market method of inventory valuation.

Cost of goods manufactured during the year is added to beginning inventory. This cost is made up of three items: direct materials, direct labor, and overhead. Materials cost of $1,127,100 is listed on line 2; this includes subcontracted parts as well as raw materials. Salaries and wages of $402,000 are entered on line 3. This amount includes wages paid to production-line workers and also the part of supervisory salaries attributable to actual production of goods. Do not deduct payments already deducted on lines 12 or 13 of page 1.

Other costs of $163,300 appear on line 4b. The supporting itemization is not illustrated, but these costs consist basically of factory overhead such as electricity, fuel, water, small tools, and depreciation on production-line machinery. Note that this depreciation ($12,400) represents depreciation on the assets used in the direct operations of the business.

Check boxes. All applicable boxes on line 8 of Schedule A should be checked.

Schedule C. Dividend income amounted to $10,000, all of which qualified for the 80% dividends-received deduction, line 2, because Tentex is a 20%-or-more owner. This total is shown both here and on line 4 of page 1. The total dividends-received deduction is figured here and entered on line 29b of page 1.

Schedule E. You should complete this schedule only if your total receipts (line 1a plus lines 4 through 10 of page 1) are $500,000 or more. (Tentex meets this requirement.) Since Tentex has only three corporate officers, these are the only entries on the schedule. Only compensation for services rendered is included here. Do not include dividends on stock held by the corporate officers.

Page 3

Schedule J. Schedule J is used to figure the corporation's tax. Applying the rates to Tentex's taxable income of $200,350 results in an income tax figure of $61,387. This figure is decreased by the jobs credit of $6,000, resulting in a total tax of $55,387.

The jobs credit is figured by multiplying $15,000 of wages paid to five qualified summer youth clerical employees (who were certified as members of a targeted group) in their first year of employment by the 40% rate. Each member earned $3,000 in salary in 1990. Form 5884 (not illustrated) must be filed with Tentex's return to support these credits.

The other taxes and credits listed on Schedule J do not apply to Tentex for 1990.

Additional information. All applicable questions on page 3 must be answered for the return to be complete.

Page 4

Schedule L. Comparative balance sheets for the beginning and end of the tax year must be shown on Schedule L. Entries on this page should agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing on Schedule A. Note that the appropriated retained earnings of Tentex increased from

$30,000 to $40,000 during the year, due to the setting aside of $10,000 as a reserve for contingencies. This amount was taken out of unappropriated retained earnings, as shown on Schedule M–2.

Schedules M–1 and M–2 must be completed if the total assets (line 15, column (d), Schedule L) are $25,000 or more. To properly complete these schedules, you must first get additional information from your corporation's books and records. The following profit and loss account appeared in the books of Tentex for the calendar year 1990.

Account		Debit	Credit
Gross sales			$2,010,000
Sales returns and allowances		$ 20,000	
Cost of goods sold		1,520,000	
Dividends received			10,000
Interest income (on state bonds)	$ 5,000		
(other—taxable)	4,500		9,500
Other income			1,000
Proceeds of life insurance			9,500
Premiums on life insurance		9,500	
Compensation of officers		70,000	
Salaries and wages—indirect		44,000	
Repairs		800	
Bad debts		1,600	
Rental expense		9,200	
Taxes		15,000	
Interest expense (on loan to buy tax-exempt bonds)	$ 850		
(other)	27,200	28,050	
Contributions (deductible)	$24,000		
(nondeductible)	500	24,500	
Depreciation—indirect		3,580	
Advertising		8,700	
Other expenses of operation		78,300	
Loss on securities		3,600	
Federal income tax accrued		55,387	
Net income per books after tax		147,783	
Total		$2,040,000	$2,040,000

Retained earnings were analyzed and the following appeared in this account in the books of the corporation:

Item	Debit	Credit
Balance, January 1, 1990		$238,000
Net profit (before federal income tax)		203,170
Reserve for contingencies	$ 10,000	
Income tax accrued for 1990	55,387	
Dividends paid during 1990	65,000	
Refund of 1988 income tax		18,000
Balance, December 31, 1990	328,783	
Total	$459,170	$459,170

Schedule M–1. Schedule M–1 starts with the net income per books, after allowance of federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 28, page 1.

Line 1. This is the net income per books, $147,783, shown in the profit and loss account previously as net income per books after tax.

Line 2. This is the federal income tax accrued for the year of the return, $55,387.

Line 3. This is for the capital losses that exceed capital gains. The net loss on securities, $3,600, is entered on this line.

Line 4. This should show all income and credits included in income subject to tax that are not recorded on the books for this year. This can happen if assets are valued in the corporate books at an amount greater than that used for tax purposes. When a sale of such assets is made, the gain included in taxable income is greater than that recorded on the books, and the difference is shown here.

Line 5. This is for expenses recorded on the corporation's books that may not be deducted. Besides the $850 listed on line 5b as contributions that were over the 10% limit, the remaining nondeductible expenses are shown in an itemized statement attached to the return, which is not illustrated, that would include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	950
Nondeductible contributions	500
Reduction of salaries by jobs credit	6,000
Total	$16,850

Line 6. This is the total of lines 1 through 5.

Line 7. This shows nontaxable income recorded on the corporation's books during the year that is not on the return. This totals $14,500 and includes insurance proceeds of $9,500 and interest on state bonds of $5,000.

Line 8. This includes all deductions claimed for tax purposes that are not recorded in the corporation's books. Tentex enters $1,620 on line 8a; it represents the difference between depreciation claimed on the tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there was not enough space on the line, it would have to attach a statement to the return listing them.

Line 9. This shows the total of lines 7 and 8, or $16,120.

Line 10. The difference, $208,350, between lines 6 and 9 must agree with line 28, page 1, *Taxable income before net operating loss deduction and special deductions.*

Schedule M–2. Schedule M–2 analyzes the unappropriated retained earnings as shown in Schedule L, the corporation's balance sheets.

Line 1. This shows the figure taken from Schedule L for the beginning of the tax year. Tentex enters $238,000 on this line.

Line 2. This is the net income per books (after federal income tax), $147,783.

Line 3. This must show all other increases to retained earnings. The refund of 1988 income tax, $18,000, is entered on this line.

Line 4. This shows the total of lines 1, 2, and 3.

Line 5. This must include all distributions to shareholders charged to retained earnings during the tax year. The dividends paid, $65,000, are shown on this line.

Line 6. This is for any decreases (other than those on Line 5) in unappropriated retained earnings. These decreases are not deductible on the tax return at the time of the appropriation, but a deduction may be allowable at a later date. A common example is amounts set aside for contingencies. A customer was injured on company property during 1990 and the company retained an attorney. A contingent liability of $10,000 was set up for the customer's claim. If this claim is settled during 1991 for $5,000 and the attorney's fee is $2,500, the retained earnings (appropriated) would be charged $7,500. The $7,500 would be deducted in arriving at taxable income for 1991. Another common example of items entered on this line is the payment of prior year's federal tax. A schedule must be attached to the return listing all items taken into account to arrive at the amount shown on this line.

Line 7. This shows the total of lines 5 and 6.

Line 8. This shows the retained earnings of the corporation at the end of the tax year for which the return is made. This figure is determined by subtracting the total on line 7 from the total on line 4. The figure must agree with the amount shown on Schedule L for the end of the year for which the return is made. As shown, $328,783 is entered on Schedule L.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1990 or tax year beginning _____, 1990, ending _____, 19____
▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No. 1545-0123

1990

Check if a—
A Consolidated return ☐
B Personal holding co. ☐
C Personal service corp. (as defined in Temp. Regs. sec. 1.441-4T—see instructions) ☐

Use IRS label. Otherwise, please print or type.

10-0395674 DEC90 071 3998
TENTEX TOYS, INC.
36 DIVISION STREET
ANYTOWN, IL 60930

D Employer identification number

E Date incorporated 3-1-72

F Total assets (see Specific Instructions) $ 879,417

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address

Income	1a	Gross receipts or sales $2,010,000	b Less returns and allowances $ 20,000	c Bal ▶ 1c	1,990,000
	2	Cost of goods sold (Schedule A, line 7)		2	1,520,000
	3	Gross profit (line 1c less line 2)		3	470,000
	4	Dividends (Schedule C, line 19)		4	10,000
	5	Interest		5	4,500
	6	Gross rents		6	
	7	Gross royalties		7	
	8	Capital gain net income (attach Schedule D (Form 1120))		8	
	9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)		9	
	10	Other income (see instructions—attach schedule)		10	1,000
	11	**Total income**—Add lines 3 through 10 ▶		11	485,500
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)		12	70,000
	13a	Salaries and wages 44,000	b Less jobs credit 6,000	c Balance ▶ 13c	38,000
	14	Repairs		14	800
	15	Bad debts		15	1,600
	16	Rents		16	9,200
	17	Taxes		17	15,000
	18	Interest		18	27,200
	19	Contributions (**see instructions for 10% limitation**)		19	23,150
	20	Depreciation (attach Form 4562)	20 17,600		
	21	Less depreciation claimed on Schedule A and elsewhere on return	21a 12,400	21b	5,200
	22	Depletion		22	
	23	Advertising		23	8,700
	24	Pension, profit-sharing, etc., plans		24	
	25	Employee benefit programs		25	
	26	Other deductions (attach schedule)		26	78,300
	27	**Total deductions**—Add lines 12 through 26 ▶		27	277,150
	28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)		28	208,350
	29	**Less:** a Net operating loss deduction (see instructions)	29a		
		b Special deductions (Schedule C, line 20)	29b 8,000	29c	8,000
Tax and Payments	30	**Taxable income**—Line 28 less line 29c		30	200,350
	31	**Total tax** (Schedule J, line 10)		31	55,387
	32	**Payments:** a 1989 overpayment credited to 1990 32a			
		b 1990 estimated tax payments 32b 69,117			
		c Less 1990 refund applied for on Form 4466 32c ( ) d Bal ▶	32d 69,117		
		e Tax deposited with Form 7004	32e		
		f Credit from regulated investment companies (attach Form 2439)	32f		
		g Credit for Federal tax on fuels (attach Form 4136). See Instructions	32g	32h	69,117
	33	Enter any **penalty** for underpayment of estimated tax—Check ▶ ☐ if Form 2220 is attached		33	
	34	**Tax due**—If the total of lines 31 and 33 is larger than line 32h, enter amount owed		34	
	35	**Overpayment**—If line 32h is larger than the total of lines 31 and 33, enter amount overpaid		35	13,730
	36	Enter amount of line 35 you want: **Credited to 1991 estimated tax** ▶ 13,730	**Refunded** ▶	36	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

James Q. Barclay — Signature of officer
3-7-91 — Date
President — Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Schedule A Cost of Goods Sold (See Instructions for line 2, page 1.)

1 Inventory at beginning of year	1	126,000	
2 Purchases	2	1,127,100	
3 Cost of labor	3	402,000	
4a Additional section 263A costs (see Instructions—attach schedule)	4a		
b Other costs (attach schedule)	4b	163,300	
5 **Total**—Add lines 1 through 4b	5	1,818,400	
6 Inventory at end of year	6	298,400	
7 **Cost of goods sold**—Line 5 less line 6. Enter here and on line 2, page 1	7	1,520,000	

8a Check all methods used for valuing closing inventory:
- (i) ☐ Cost (ii) ☑ Lower of cost or market as described in Regulations section 1.471-4 (see Instructions)
- (iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c) (see Instructions)
- (iv) ☐ Other (Specify method used and attach explanation.) ▶

b Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO — 8c

d Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? ☑ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

Schedule C Dividends and Special Deductions (See Instructions.)

	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1 Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2 Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)	10,000	80	8,000
3 Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see Instructions	
4 Dividends on certain preferred stock of less-than-20%-owned public utilities		41.176	
5 Dividends on certain preferred stock of 20%-or-more-owned public utilities		47.059	
6 Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7 Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8 Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9 **Total**—Add lines 1 through 8. See Instructions for limitation			8,000
10 Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11 Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12 Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13 Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14 Income from controlled foreign corporations under subpart F (attach Forms 5471)			
15 Foreign dividend gross-up (section 78)			
16 IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17 Other dividends			
18 Deduction for dividends paid on certain preferred stock of public utilities (see Instructions)			
19 **Total dividends**—Add lines 1 through 17. Enter here and on line 4, page 1. ▶	10,000		
20 **Total deductions**—Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			8,000

Schedule E Compensation of Officers (See Instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a, plus lines 4 through 10, of page 1, Form 1120) are $500,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1 James Q. Barclay	581-00-0936	100 %	45 %	%	40,000
		%	%	%	
George M. Collins	447-00-2604	100 %	15 %	%	21,000
		%	%	%	
Samuel Adams	401-00-2611	50 %	2 %	%	9,000
2 Total compensation of officers					70,000
3 **Less:** Compensation of officers claimed on Schedule A and elsewhere on return					( )
4 Compensation of officers deducted on line 12, page 1					70,000

Schedule J Tax Computation

1	Check if you are a member of a controlled group (see sections 1561 and 1563) ▶ ☐		
2	If the box on line 1 is checked:		
a	Enter your share of the $50,000 and $25,000 taxable income bracket amounts (in that order): (i) $ (ii) $		
b	Enter your share of the additional 5% tax (not to exceed $11,750) ▶ $		
3	Income tax (see Instructions to figure the tax). Check this box if the corporation is a qualified personal service corporation (see Instructions on page 12). ▶ ☐	3	61,387
4a	Foreign tax credit (attach Form 1118)	4a	
b	Possessions tax credit (attach Form 5735)	4b	
c	Orphan drug credit (attach Form 6765)	4c	
d	Credit for fuel produced from a nonconventional source (see Instructions)	4d	
e	General business credit. Enter here and check which forms are attached: ☐ Form 3800 ☐ Form 3468 ☑ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586	4e	6,000
f	Credit for prior year minimum tax (attach Form 8801)	4f	
5	**Total**—Add lines 4a through 4f	5	6,000
6	Line 3 less line 5	6	55,387
7	Personal holding company tax (attach Schedule PH (Form 1120))	7	
8	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	8	
9a	Alternative minimum tax (attach Form 4626). See Instructions	9a	
b	Environmental tax (attach Form 4626)	9b	
10	**Total tax**—Add lines 6 through 9b. Enter here and on line 31, page 1	10	55,387

Additional Information (See General Instruction F.)

		Yes	No
H	Refer to the list in the Instructions and state the principal:		
	(1) Business activity code no. ▶ 3998		
	(2) Business activity ▶ Manufacturing		
	(3) Product or service ▶ Toys		
I	(1) Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year.		✓
	(2) Did any individual, partnership, corporation, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes," complete (a) through (c)		✓
	(a) Attach a schedule showing name, address, and identifying number.		
	(b) Enter percentage owned ▶		
	(c) Was the owner of such voting stock a foreign person? (See Instructions.) **Note:** *If "Yes," the corporation may have to file Form 5472*		
	If "Yes," enter owner's country ▶		
J	Was the corporation a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 5471 for each such corporation.		✓
K	At any time during the tax year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See General Instruction F and filing requirements for form TD F 90-22.1.) If "Yes," enter name of foreign country ▶		✓
L	Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation has any beneficial interest in it? If "Yes," the corporation may have to file Forms 3520, 3520-A, or 926.		✓
M	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on **Form 851**, Affiliations Schedule, for each subsidiary.		✓
N	During this tax year, did the corporation maintain any part of its accounting/tax records on a computerized system?		✓
O	Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶		
P	Check this box if the corporation issued publicly offered debt instruments with original issue discount ☐ If so, the corporation may have to file Form 8281.		
Q	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ 5,000		
R	Enter the number of shareholders at the end of the tax year if there were 35 or fewer shareholders ▶		

Schedule L Balance Sheets

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		14,700		28,331
2a Trade notes and accounts receivable	98,400		103,700	
b Less allowance for bad debts	( )	98,400	( )	103,700
3 Inventories		126,000		298,400
4 U.S. government obligations				
5 Tax-exempt securities (see Instructions)		100,000		120,000
6 Other current assets (attach schedule)		26,300		17,266
7 Loans to stockholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)		100,000		80,000
10a Buildings and other depreciable assets	272,400		296,700	
b Less accumulated depreciation	(88,300)	184,100	(104,280)	192,420
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)		20,000		20,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach schedule)		14,800		19,300
15 Total assets		684,300		879,417
Liabilities and Stockholders' Equity				
16 Accounts payable		28,500		34,834
17 Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18 Other current liabilities (attach schedule)		6,800		7,400
19 Loans from stockholders				
20 Mortgages, notes, bonds payable in 1 year or more		176,700		264,100
21 Other liabilities (attach schedule)				
22 Capital stock: a Preferred stock				
b Common stock	200,000	200,000	200,000	200,000
23 Paid-in or capital surplus				
24 Retained earnings—Appropriated (attach schedule)		30,000		40,000
25 Retained earnings—Unappropriated		238,000		328,783
26 Less cost of treasury stock		( )		( )
27 Total liabilities and stockholders' equity		684,300		879,417

Schedule M-1 Reconciliation of Income per Books With Income per Return

(This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books	147,783	7 Income recorded on books this year not included on this return (itemize):	
2 Federal income tax	55,387	a Tax-exempt interest $ 5,000	
3 Excess of capital losses over capital gains	3,600	b Insurance Proceeds 9,500	14,500
4 Income subject to tax not recorded on books this year (itemize):		8 Deductions on this return not charged against book income this year (itemize):	
5 Expenses recorded on books this year not deducted on this return (itemize):		a Depreciation $ 1,620	
a Depreciation $		b Contributions carryover $	
b Contributions carryover $ 850			1,620
c Travel and entertainment $ See Itemized Statement Attached $16,850	17,700	9 Total of lines 7 and 8	16,120
6 Total of lines 1 through 5	224,470	10 Income (line 28, page 1)—line 6 less line 9	208,350

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (line 25, Schedule L)

(This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Balance at beginning of year	238,000	5 Distributions: a Cash	65,000
2 Net income per books	147,783	b Stock	
3 Other increases (itemize): Refund of 1988 Income Tax Due to IRS Examination	18,000	c Property	
		6 Other decreases (itemize): Reserve for Contingencies	10,000
		7 Total of lines 5 and 6	75,000
4 Total of lines 1, 2, and 3	403,783	8 Balance at end of year (line 4 less line 7)	328,783

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